ACCA

Applied Knowledge

ACCA Diploma in Accounting and Business (RQF Level 4)

Financial Accounting (FA/FFA)

Study Text

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These materials are reviewed by the ACCA examining team. The objective of the review is to ensure that the material properly covers the syllabus and study guide outcomes, used by the examining team in setting the exams, in the appropriate breadth and depth. The review does not ensure that every eventuality, combination or application of examinable topics is addressed by the ACCA Approved Content. Nor does the review comprise a detailed technical check of the content as the Approved Content Provider has its own quality assurance processes in place in this respect.

Contents

Introduction

This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2022 IFRS Standards Red Book.

How to use the Materials

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your examinations.

The product range contains a number of features to help you in the study process. They include:

(1) Detailed study guide and syllabus objectives

(2) Description of the examination

(3) Study skills and revision guidance

(4) Study text

(5) Question practice

The sections on the study guide, the syllabus objectives, the examination and study skills should all be read before you commence your studies. They are designed to familiarise you with the nature and content of the examination and give you tips on how to best approach your learning.

The **Study text** comprises the main learning materials and gives guidance as to the importance of topics and where other related resources can be found. Each chapter includes

- The **learning objectives** contained in each chapter, which have been carefully mapped to the examining body's own syllabus learning objectives or outcomes. You should use these to check you have a clear understanding of all the topics on which you might be assessed in the examination.
- The **chapter diagram** provides a visual reference for the content in the chapter, giving an overview of the topics and how they link together.
- The **content** for each topic area commences with a brief explanation or definition to put the topic into context before covering the topic in detail. You should follow your studying of the content with a review of the illustration/s. The illustrations are worked examples which will help you to understand better how to apply the content for the topic.
- **Test your understanding** sections provide an opportunity to assess your understanding of the key topics by applying what you have learned to short questions. Answers can be found at the back of each chapter.
- **Summary diagrams** complete each chapter to show the important links between topics and the overall content of the syllabus. These diagrams should be used to check that you have covered and understood the core topics before moving on.
- **Question practice** is provided at the back of each text.

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Our Quality Coordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon Explanations

Definition – Key definitions that you will need to learn from the core content.

Key point – Identifies topics that are key to success and are often examined.

Test your understanding – Exercises for you to complete to ensure that you have understood the topics just learned.

Illustration – Worked examples help you understand the core content better.

Tricky topic – When reviewing these areas care should be taken and all illustrations and Test your understanding exercises should be completed to ensure that the topic is understood.

Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an exam question. **Reference to this text is vital when self-studying**.

Links to other syllabus areas – This symbol refers to areas of interaction with other parts of your syllabus, either in terms of other ACCA subjects that you have studied, or may go on to study, or even further professional qualifications that you may decide to pursue on completion of ACCA.

On-line subscribers

Our on-line resources are designed to increase the flexibility of your learning materials and provide you with immediate feedback on how your studies are progressing.

If you are subscribed to our on-line resources you will find:

(1) On-line reference ware: reproduces your Study Text on-line, giving you anytime, anywhere access.

(2) On-line testing: provides you with additional on-line objective testing so you can practise what you have learned further.

(3) On-line performance management: immediate access to your on-line testing results. Review your performance by key topics and chart your achievement through the course relative to your peer group.

Syllabus introduction

Syllabus background

The aim of ACCA **Financial Accounting (FA)**, Diploma in Accounting and Business, is to develop knowledge and understanding of the underlying principles and concepts relating to financial accounting and technical proficiency in the use of double-entry accounting techniques including the preparation of basic financial statements.

Objectives and core areas of the syllabus

- Explain the context and purpose of financial reporting.
- Define the accounting principles, concepts and qualitative characteristics of financial information.
- Demonstrate the use of double-entry and accounting systems.
- Record transactions and events.
- Perform reconciliations.
- Prepare a trial balance.
- Prepare financial statements.
- Prepare basic consolidated financial statements
- Interpret financial statements

ACCA Performance Objectives

In order to become a member of the ACCA, as a trainee accountant you will need to demonstrate that you have achieved nine performance objectives. Performance objectives are indicators of effective performance and set the minimum standard of work that trainees are expected to achieve and demonstrate in the workplace. They are divided into key areas of knowledge which are closely linked to the exam syllabus.

There are five Essential performance objectives and a choice of fifteen Technical performance objectives which are divided into five areas.

The performance objectives which link to this exam are:

(1) Ethics and professionalism PO1 (Essential)

(2) Record and process transactions and events PO6 (Technical)

(3) Prepare external financial reports PO7 (Technical)

(4) Analyse and interpret financial reports PO8 (Technical)

The following link provides an in depth insight into all of the performance objectives:

https://www.accaglobal.com/content/dam/ACCA_Global/Students/per/PER-Performance-objectives-achieve.pdf

Progression

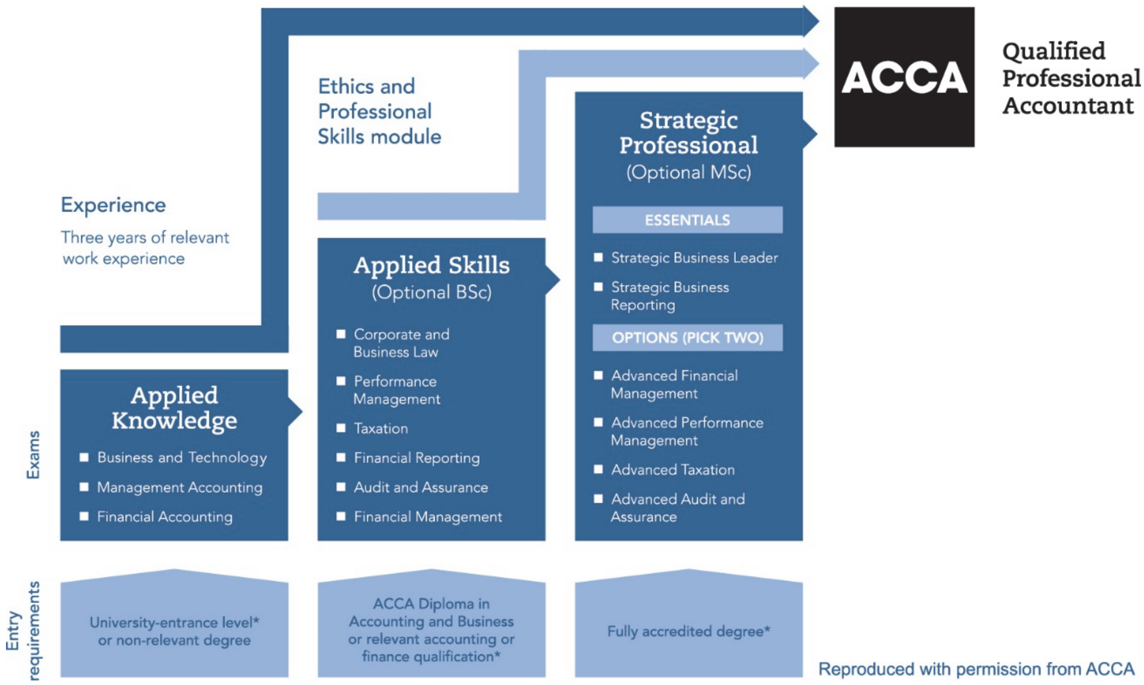
There are two elements of progression that we can measure: first how quickly students move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier exams provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. We know that exams encourage techniques that lead to some degree of short-term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.



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Syllabus objectives

We have reproduced the ACCA's syllabus below, showing where the objectives are explored within this book. Within the chapters, we have broken down the extensive information found in the syllabus into easily digestible and relevant sections, called Content Objectives. These correspond to the objectives at the beginning of each chapter.

Syllabus learning objective			Chapter reference
A	**THE CONTEXT AND PURPOSE OF FINANCIAL REPORTING**		
1	**The scope and purpose of financial statements for external reporting**		
	(a)	Define financial reporting – recording, analysing and summarising financial data.[k]	1
	(b)	Identify and define types of business entity – sole trader, partnership, limited liability company.[k]	1
	(c)	Explain the legal differences between a sole trader, partnership and a limited liability company.[k]	1
	(d)	Identify the advantages and disadvantages of operating as a sole trader, partnership and a limited liability company.[k]	
	(e)	Define the nature, principles and scope of financial reporting.[k]	1
2	**Stakeholders' needs**		
	(a)	Identify the users of financial statements and state and differentiate between their information needs.[k]	1
3	**The main elements of financial statements**		
	(a)	Describe the purpose of each of the main financial statements.[k]	1
	(b)	Identify and define and assets, liabilities, equity, income and expenses.[k]	1
4	**The regulatory framework**		
	(a)	Explain the purpose of the regulatory system including the roles of the IFRS® Foundation (the Foundation), the International Accounting Standards Board (The Board), the IFRS Advisory Council (IFRS AC) the IFRS Interpretations Committee (IFRIC®) and the International Sustainability Standards Board (ISSB®).[k]	2
	(b)	Explain the role of the International Financial Reporting Standards (IFRS Standards®) in preparing financial statements.[k]	2

Syllabus learning objective	Chapter reference
5 Duties and responsibilities of those charged with governance	2
(a) Explain what is meant by governance specifically in the context of the preparation of financial statements.[k]	
(b) Describe the duties and responsibilities of directors in the preparation of the financial statements.[k]	
B ACCOUNTING PRINCIPLES, CONCEPTS AND QUALITATIVE CHARACTERISTSCS	
1 Key principles and concepts of accounting	2
(a) Define and apply key principles and concepts of accounting:[k]	
(i) Going concern	
(ii) Accruals basis	
(iii) Materiality and aggregation	
(iv) Offsetting	
(v) Consistency	
(vi) Prudence	
(vii) Duality (dual aspect)	
(viii) Business entity	
(ix) Historical cost and current value	
(x) Substance over form	
2 Qualitative characteristics of useful financial information	2
(a) Define and apply the qualitative characteristics of useful financial information:[k]	
(i) Relevance	
(ii) Faithful representation	
(iii) Comparability	
(iv) Verifiability	
(v) Timeliness	
(vi) Understandability.	

C THE USE OF DOUBLE-ENTRY AND ACCOUNTING SYSTEMS

1 Double-entry bookkeeping principles including the maintenance of accounting records

(a)	Identify and explain the function of the main data sources in an accounting system.[k]	3
(b)	Summarise the contents and purpose of different types of business documentation, including:[k] (i) Quotation (ii) Sales order (iii) Purchase order (iv) Goods received note (v) Goods despatched note (vi) Sales invoice (vii) Supplier (purchase) invoice (viii) Supplier statement (ix) Credit note (x) Debit note (x) Remittance advice (iii) Receipt	3
(c)	Explain and apply the accounting equation.[k]	
(d)	Describe the key features of a computerised accounting system, including the use of external servers to store data (the cloud).[k]	3
(e)	Describe how the accounting system contributes to providing useful accounting information and complies with organisational policies and deadlines.[k]	1, 3
(f)	Identify the main types of business transactions e.g. sales, purchases, payments, receipts.[k]	3

2 General ledger accounts and journal entries

(a)	Describe the main types of general ledger accounts including their nature and function.[k]	3
(b)	Describe how financial data is initially recorded in the accounting system.[s]	3
(c)	Explain the use of journal entries and how journal entries are posted into general ledger accounts.[s]	
(d)	Identify correct journals from given narrative.[s]	3
(e)	Illustrate how to balance and close the general ledger accounts at the year end.[s]	3

D RECORDING TRANSACTIONS AND EVENTS

1 Sales and purchases

(a)	Record sale and purchase transactions in the general ledger accounts.[s]	4
(b)	Record sales returns and purchase returns in the general ledger accounts.[s]	4
(c)	Describe the principles of the operation of a sales tax.[k]	4
(d)	Calculate sales tax on transactions and record the consequent accounting entries.[s]	4
(e)	Account for discounts received.[s]	4
(f)	Account for discounts allowed (trade discounts and settlement discounts) to customers in accordance with IFRS 15 *Revenue from Contracts with Customers*.[s]	4

2 Cash

(a)	Record cash transactions in the bank general ledger account.[s]	4
(b)	Describe the need for a record of petty cash transactions.[k]	4

3 Inventories

(a)	Describe the need for adjustments to inventories in preparing financial statements.[k]	5
(b)	Record opening and closing inventories.[s]	5
(c)	Apply the requirements of IAS 2 *Inventories* for valuing inventories.[s]	
(d)	Identify which costs should be included in valuing inventories.[s]	5
(e)	Explain the use of continuous and period end inventory records.[k]	5
(f)	Calculate the value of closing inventory using FIFO (first in, first out) and AVCO (average cost) – both periodic weighted average and continuous weighted average.[s]	5
(g)	Identify the impact of inventory valuation methods on profit and on assets. [s]	

4	**Tangible non-current assets**		
	(a)	Define non-current assets.[k]	1 & 6
	(b)	Compare the difference between current and non-current assets.[k]	1 & 6
	(c)	Explain the difference between asset and expense items.[k]	6
	(d)	Classify expenditure as asset expenditure or expenses charged to profit or loss.[s]	6
	(e)	Record the acquisition and disposal of tangible non-current assets in the general ledger accounts in accordance with IAS 16 *Property, Plant and Equipment*.[s]	6
	(f)	Calculate and record gains or losses on disposal of tangible non-current assets in the general ledger accounts and illustrate how it is presented in the statement of profit or loss, including part exchange transactions. [s]	6
	(g)	Record the revaluation of a tangible non-current asset in the general ledger accounts, and illustrate how it is presented in the statement of profit or loss and other comprehensive income and in the statement of financial position.[s]	6
	(h)	Calculate the gain or loss on disposal of a revalued tangible non-current asset.[s]	7
	(i)	Illustrate how tangible non-current asset balances and movements are disclosed in financial statements.[s]	6 & 7
	(j)	Explain the purpose and function of a non-current asset register.[k]	6
5	**Depreciation**		
	(a)	Explain the purpose of depreciation.[k]	6
	(b)	Calculate the charge for depreciation using straight line and diminishing (reducing) balance methods.[s]	6
	(c)	Identify the circumstances where different methods of depreciation would be appropriate.[k]	6
	(d)	Illustrate how the depreciation expense and accumulated depreciation are recorded in the general ledger accounts.[s]	6
	(e)	Calculate and update the general ledger accounts to record the depreciation on a revalued tangible non-current asset, including the transfer of excess depreciation between the revaluation surplus and retained earnings.[s]	7

	(f)	Calculate the adjustments to depreciation necessary if changes are made in the estimated useful life and/or residual value of a tangible non-current asset.[s]	6
	(g)	Record depreciation in the statement of profit or loss and statement of financial position.[s]	6
6	**Intangible non-current assets and amortisation**		
	(a)	Compare the difference between tangible and intangible non-current assets.[k]	8
	(b)	Identify types of intangible assets.[k]	8
	(c)	Identify the definition and treatment of 'research' and 'development' in accordance with IAS 38 *Intangible Assets*.[k]	8
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	(b)	Calculate the adjustments needed for accruals, prepayments, accrued income and deferred income when preparing financial statements.[s]	9
	(c)	Illustrate the process of adjusting for accruals, prepayments, accrued income and deferred income when preparing financial statements.[s]	9
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	(e)	Identify the impact of accruals, prepayments, accrued income and deferred income in the financial statements.[s]	9
	(f)	Report accruals, prepayments, accrued income and deferred income in the financial statements.[s]	9
8	**Receivables and payables**		
	(a)	Identify and explain examples of receivables and payables.[k]	1 & 10 & 11
	(b)	Identify the benefits and costs of offering credit facilities to customers.[k]	10

	(c)	Describe the purpose of an aged receivables analysis.[k]	10
	(d)	Describe the purpose of customer credit limits.[k]	10
	(e)	Prepare the journal entries to write off an irrecoverable debt.[s]	10
	(f)	Record an irrecoverable debt recovered.[s]	10
	(g)	Demonstrate the impact of irrecoverable debts on the statement of profit or loss and on the statement of financial position.[s]	10
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	(i)	Illustrate how to include movements in the allowance for receivables in the statement of profit or loss and how the closing balance of the allowance should appear in the statement of financial position.[s]	10
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9	**Provisions and contingencies**		
	(a)	Define ‘provision’, ‘contingent liability’ and ‘contingent asset’ in accordance IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.[k]	11
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	(d)	Calculate provisions and changes in provisions.[s]	11
	(e)	Account for the movement in provisions.[s]	11
	(f)	Report provisions in the financial statements.[s]	11

10 Capital structure and finance costs

(a) Describe the capital structure of a limited liability company including: [k] — 12

- (i) ordinary shares
- (ii) preference shares (redeemable and irredeemable)
- (iii) borrowings.

(b) Describe the nature of equity, including retained earnings and other components of equity.[K] — 12

(c) Identify and record the other components of equity which may appear in the statement of financial position.[s] — 12

(d) Record movements in the share capital and share premium accounts.[s] — 12

(e) Define a bonus (capitalisation) issue and its advantages and disadvantages.[k]

(f) Define a rights issue and its advantages and disadvantages.[k] — 12

(g) Calculate and record a bonus (capitalisation) issue in the statement of financial position.[s] — 12

(h) Calculate and record a rights issue in the statement of financial position.[s] — 12

(i) Calculate and record dividends in the general ledger accounts and the financial statements.[s] — 12

(j) Calculate and record finance costs in the general ledger accounts and the financial statements.[s] — 12

(k) Identify the components of the statement of changes in equity.[k] — 12

E RECONCILIATIONS

1 Bank reconciliations

(a) Explain the purpose of bank reconciliations.[K] — 13

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(c) identify and correct errors and/or omissions in the bank general ledger account.[S]

(d) Prepare the reconciliation of the bank general ledger account to the bank statement or internet banking records.[S]

(e) Derive bank statement and bank general ledger account balances from given information.[S]

(f) identify the bank balance to be reported in the financial statements.[S]

2	**Trade payables account reconciliation**		
	(a)	Explain the purpose of the trade payables' general ledger account and how it relates to the double-entry system.[K]	13
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	(d)	Explain the limitations of a trial balance.[k]	14
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	(c)	Record entries in a suspense account.[s]	14
	(d)	Prepare journal entries to clear a suspense account.[s]	14

G	**PREPARING FINANCIAL STATEMENTS**	
1	**Statement of financial position**	
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	(b) Prepare a statement of financial position or extracts as applicable.[s]	
2	**Statement of profit or loss and other comprehensive income**	
	(a) Calculate revenue, cost of sales, gross profit, profit from operations, profit before tax, profit for the year and total comprehensive income from given information.[s]	15
	(b) Prepare a statement of profit or loss and other comprehensive income or extracts as applicable.[s]	1 & 15
	(c) Record income tax in the statement of profit or loss of a company, including the under and overprovision of tax in the prior year.[s]	12
	(d) Identify items requiring separate disclosure on the face of the statement of profit or loss.[k]	15
	(e) Explain the interrelationship between the statement of financial position and the statement of profit or loss and other comprehensive income.[k]	15
3	**Disclosure notes**	
	(a) Explain the purpose of notes to the financial statements (disclosure notes).[k]	15
	(b) Draft the following disclosure notes.[s]	
	(i) Non-current assets including tangible and intangible assets	6
	(ii) Provisions	11
	(iii) Events after the reporting period	15
	(iv) Inventories.	5
4	**Events after the reporting period**	
	(a) Define an event after the reporting period in accordance with IAS 10 *Event after the Reporting Period*.[k]	15
	(b) Classify events as adjusting or non-adjusting.[s]	15
	(c) Distinguish between how adjusting and non-adjusting events are reported in the financial statements.[k]	15

5	**Statements of cash flows (excluding partnerships)**		
	(a)	Differentiate between profit and cash flow.[k]	17
	(b)	Describe the need for management to control cash flow.[k]	17
	(c)	Explain the benefits and drawbacks to users of the financial statements of a statement of cash flows.[k]	17
	(d)	Classify the effect of transactions on cash flows.[s]	17
	(e)	Calculate the figures needed for the statement of cash flows in accordance with IAS 7 *Statement of Cash Flows* including:[s] (i) cash flows from operating activities (direct and indirect methods) (ii) cash flows from investing activities (iii) cash flows from financing activities.	17
	(f)	Prepare a statement of cash flows or extracts as applicable.[s]	17
	(g)	Identify the treatment of given transactions in a statement of cash flows.[k]	17
6	**Incomplete records**		
	(a)	Apply techniques used in incomplete record situations:[s] (i) use of accounting equation (ii) use of general ledger accounts to calculate missing figures (iii) use of cash and/or bank summaries (iv) use of profit percentages to calculate missing figures.	16

H PREPARING BASIC CONSOLIDATED FINANCIAL STATEMENTS

1 Subsidiaries

(a) Define and describe the following terms in the context of group accounting.[k] 19

(i) Parent

(ii) Subsidiary

(iii) Control

(iv) Consolidated (group) financial statements

(v) Non-controlling interest

(vi) Trade (simple) investment.

(b) Identify subsidiaries within a group structure.[k] 19

(c) Describe the components of and prepare a consolidated statement of financial position or extracts thereof including.[s] 19

(i) fair value adjustments at acquisition on property, plant and equipment (excluding depreciation adjustments)

(ii) fair value of consideration transferred from cash and shares (excluding deferred and contingent consideration)

(iii) elimination of intra-group trading balances (excluding cash and goods in transit)

(iv) removal of unrealised profit arising on intra-group trading

(v) acquisition of subsidiaries part way through the financial year.

(d) Calculate goodwill (excluding impairment of goodwill) where non-controlling interest is valued at its fair value at acquisition date as follows:[s] 19

Fair value of consideration	X
Fair value of non-controlling interest	X
Less fair value of net assets at acquisition	(X)
Goodwill at acquisition	X

	(e)	Describe the components of and prepare a consolidated statement of profit or loss or extracts thereof including:[s]	20
		(i) elimination of intra-group trading balances (excluding cash and goods in transit)	
		(ii) removal of unrealised profit arising on intra-group trading	
		(iii) acquisition of subsidiaries part way through the financial year.	
2	**Associates**		
	(a)	Define and identify an associate and significant influence and identify the situations where significant influence exists.[k]	20
	(b)	Describe the key features of a parent-associate relationship and be able to identify an associate within a group structure.[k]	20
	(c)	Describe the principle of the equity method of accounting for associate entities.[k]	20
I	**INTERPRETATION OF FINANCIAL STATEMENTS**		
1	**Importance and purpose of analysis of financial statements**		
	(a)	Describe how the interpretation and analysis of financial statements is used in a business environment.[k]	18
	(b)	Explain the purpose of interpretation of ratios.[k]	18
2	**Ratios**		
	(a)	Calculate key accounting ratios related to.[s]	
		(i) profitability	18
		(ii) liquidity	
		(iii) efficiency	
		(iv) position.	
	(b)	Explain the interrelationships between ratios.[k]	18
3	**Analysis of financial statements**		
	(a)	Calculate and interpret the relationship between the elements of the financial statements with regard to profitability, liquidity, efficient use of resources and financial position.[s]	18
	(b)	Draw valid conclusions from the information contained within the financial statements and present these to the appropriate user of the financial statements.[s]	18

The superscript numbers in square brackets indicate the intellectual depth at which the subject area could be assessed within the examination. Level 1 (knowledge and comprehension) broadly equates with Applied Knowledge, Level 2 (application and analysis) with Applied Skills and Level 3 (synthesis and evaluation) with the Strategic Professional exams. However, lower level skills can continue to be assessed as you progress through each module and level.

The examination

Do not attempt a CBE until you have **completed all study material** relating to it. **Do not skip any of the material** in the syllabus.

Examination format

The syllabus is assessed by a two-hour computer-based examination. Questions will assess all parts of the syllabus and will contain both computational and non-computational elements:

	Number of marks
Thirty-five 2-mark objective test questions	70
Two 15-mark multi-task questions	30

Total time allowed: 2 hours

The CBE question types are as follows:

- Multiple choice – where you are required to choose one answer from a list of options provided by clicking on the appropriate 'radio button'
- Multiple response – where you are required to select more than one response from the options provided by clicking on the appropriate tick boxes (typically choose two options from the available list
- Multiple response matching – where you are required to indicate a response to a number of related statements by clicking on the 'radio button' which corresponds to the appropriate response for each statement
- Number entry – where you are required to key in a response to a question shown on the screen.

The longer 15-mark multi-task questions will test consolidations and accounts preparation (including a statement of cash flows). Make sure you practice preparing full financial statements. There are lots of questions to practice in this text.

Computer-based examination (CBE) – Tips

Be sure you **understand how to use the software** before you start the exam. If in doubt, ask the assessment centre staff to explain it to you.

Questions are **displayed on the screen** and answers are entered using keyboard and mouse. At the end of the exam, you are given a certificate showing the result you have achieved.

Spend the first few minutes of the examination **reviewing the format and content** so that you understand what you need to do.

Allocate the time you spend on questions in proportion to the marks on offer. For the Financial Accounting exam, this will equate to 1.2 minutes per mark. One suggestion for this exam is to allocate 2.4 minutes to each objective test question, and 18 minutes for each multi-task question. Note that this is an average as some objective test questions may be briefer to read and/or quicker to answer (e.g. choose the correct definition from four answers available), whilst others may take longer to read and answer (e.g. a calculation question).

Read each question very carefully.

Objective test questions: Read each question carefully and work through any calculations required. For questions when you have a choice of answer available, if you don't know the answer, eliminate those options you know are incorrect and see if the answer becomes more obvious.

Answer every question – if you do not know an answer, you don't lose anything by guessing. Think carefully before you **guess**.

With an objective test question, it may be possible to eliminate first those answers that you know are wrong. Then choose the most appropriate answer(s) as required from those that are left. This could be a single answer (e.g. multiple choice) or more than one response (e.g. multiple response and multiple response – matching).

After you have eliminated the ones that you know to be wrong, if you are still unsure, guess. But only do so after you have double-checked that you have only eliminated answers that are definitely wrong.

Double-check your answer before committing yourself to it.

Don't panic if you realise you've answered a question incorrectly. Try to remain calm, continue to apply examination technique and answer all questions required within the time available.

ACCA Support

For additional support with your studies please also refer to the ACCA Global website.

Study skills and revision guidance

This section aims to give guidance on how to study for your ACCA exams and to give ideas on how to improve your existing study techniques.

Preparing to study

Set your objectives

Before starting to study decide what you want to achieve – the type of pass you wish to obtain. This will decide the level of commitment and time you need to dedicate to your studies.

Devise a study plan

Determine which times of the week you will study.

Split these times into sessions of at least one hour for study of new material. Any shorter periods could be used for revision or practice.

Put the times you plan to study onto a study plan for the weeks from now until the exam and set yourself targets for each period of study – in your sessions make sure you cover the course, course assignments and revision.

If you are studying for more than one examination at a time, try to vary your subjects as this can help you to keep interested and see subjects as part of wider knowledge.

When working through your course, compare your progress with your plan and, if necessary, re-plan your work (perhaps including extra sessions) or, if you are ahead, do some extra revision/practice questions.

Effective studying

Active reading

You are not expected to learn the text by rote, rather, you must understand what you are reading and be able to use it to pass the exam and develop good practice. A good technique to use is SQ3Rs – Survey, Question, Read, Recall, Review:

(1) **Survey** the chapter – look at the headings and read the introduction, summary and objectives, so as to get an overview of what the chapter deals with.

(2) **Question** – whilst undertaking the survey, ask yourself the questions that you hope the chapter will answer for you.

(3) **Read** through the chapter thoroughly, answering the questions and making sure you can meet the objectives. Attempt the exercises and activities in the text, and work through all the examples.

(4) **Recall** – at the end of each section and at the end of the chapter, try to recall the main ideas of the section/chapter without referring to the text. This is best done after a short break of a couple of minutes after the reading stage.

(5) **Review** – check that your recall notes are correct.

You may also find it helpful to re-read the chapter to try to see the topic(s) it deals with as a whole.

Note-taking

Taking notes is a useful way of learning, but do not simply copy out the text. The notes must:

- be in your own words
- be concise
- cover the key points
- be well-organised
- be modified as you study further chapters in this text or in related ones.

Trying to summarise a chapter without referring to the text can be a useful way of determining which areas you know and which you don't.

Three ways of taking notes:

Summarise the key points of a chapter.

Make linear notes – a list of headings, divided up with subheadings listing the key points. If you use linear notes, you can use different colours to highlight key points and keep topic areas together. Use plenty of space to make your notes easy to use.

Try a diagrammatic form – the most common of which is a mind-map. To make a mind-map, put the main heading in the centre of the paper and put a circle around it. Then draw short lines radiating from this to the main subheadings, which again have circles around them. Then continue the process from the sub-headings to sub-sub-headings, advantages, disadvantages, etc.

Highlighting and underlining

You may find it useful to underline or highlight key points in your study text – but do be selective. You may also wish to make notes in the margins.

Revision

The best approach to revision is to revise the course as you work through it.

Also try to leave four to six weeks before the exam for final revision. Make sure you cover the whole syllabus and pay special attention to those areas where your knowledge is weak. Here are some recommendations:

Read through the text and your notes again and condense your notes into key phrases. It may help to put key revision points onto index cards to look at when you have a few minutes to spare.

Review any assignments you have completed and look at where you lost marks – put more work into those areas where you were weak.

Practise exam standard questions under timed conditions. If you are short of time, list the points you would include or specify the calculations that you would include in your answer and then read the model answer, but do try to complete at least a few questions under exam conditions.

Also practise producing answer plans and comparing them to the model answer.

If you are stuck on a topic find somebody (e.g. your tutor or, where appropriate, a member of Kaplan's Academic Support team) to explain it to you.

Read good newspapers and professional journals, especially ACCA's Student Accountant – this can give you an advantage in the exam.

Ensure you **know the structure of the exam** – how many questions and of what type you will be expected to answer. During your revision attempt all the different styles of questions you may be asked.

Further reading

You can find further reading and technical articles under the student section of ACCA's website.

The following publications may also support your studies for this, and other, ACCA examinations in financial accounting and related topics:

A Student's Guide to Group Accounts by Tom Clendon, Kaplan Publishing

A Student's Guide to IFRS by Clare Finch, Kaplan Publishing

A Student's Guide to Preparing Financial Statements by Sally Baker, Kaplan Publishing.

Technical update

This text has been updated to reflect Examinable Documents September 2023 to August 2024 issued by ACCA. Please note that there are changes to the ACCA FA syllabus which take effect from September 2023.

Chapter

1

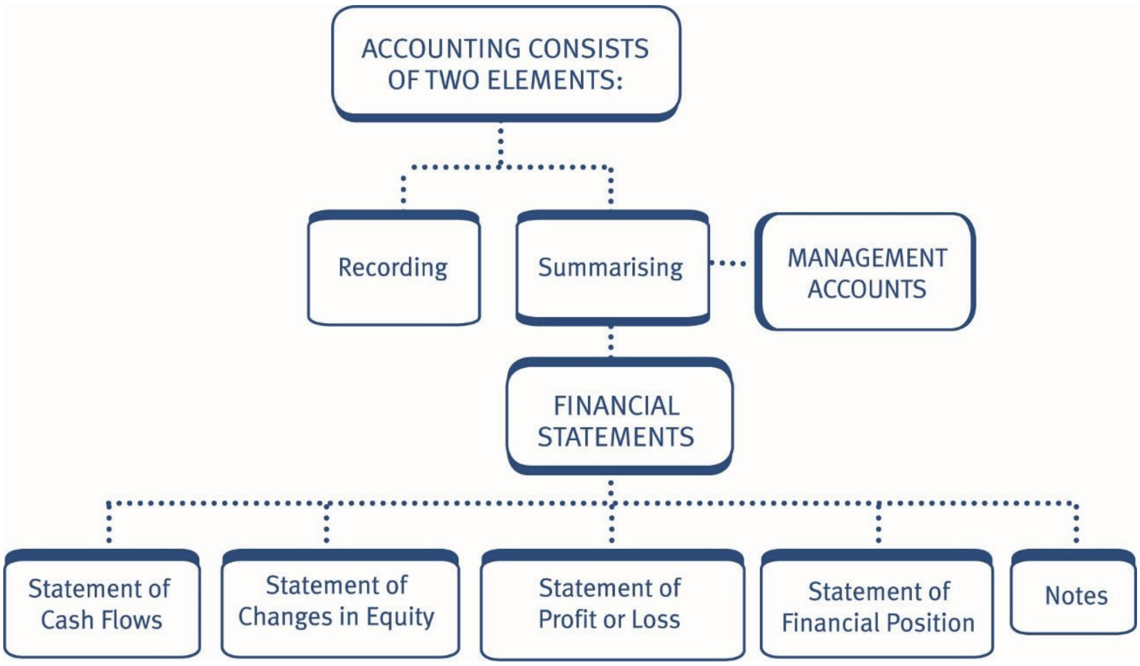
Introduction to financial reporting

Chapter learning objectives

Upon completion of this chapter you will be able to:

- define financial reporting
- identify and define types of business entity
- identify users of the financial statements and their information needs
- identify the purpose of the main financial statements
- define the elements of the financial statements
- define and explain accounting concepts and characteristics.

1 Overview of accounting



Introduction

Much of the content of this chapter is likely to be new to you. However, it forms an important foundation for your current ACCA FA studies and other exams as you progress through the ACCA qualification, particularly Financial Reporting and Strategic Business Reporting.

The financial accounting and reporting system of an entity records and summarises the financial performance and position of a business. This information is crucial to various stakeholders of the entity who will analyse that information to make significant economic decisions. It is of vital importance that these stakeholders have good quality information to be able to make good quality decisions.

Although the focus of the ACCA Financial Accounting syllabus is directed towards commercial business entities, the syllabus content can be applied to non-commercial entities such as charities, public and governmental organisations.

This chapter explores the nature of business entities and their stakeholders and identifies what their information requirements are and how this fits into the process of financial reporting.

Financial accounting and management accounting

Financial accounting

Financial accounting is initially concerned with the recording, classification and summarisation of individual transactions. From this information, annual financial statements are produced for external stakeholders such as providers of finance, and potential investors. These financial statements are a report on the directors' stewardship of the funds entrusted to them by the shareholders.

Investors need to be able to choose which companies to invest in and to evaluate their investments. In order to facilitate evaluation and comparison, financial accounts are prepared using accepted accounting conventions and standards. International Accounting Standards (IAS® Standards) and International Financial Reporting Standards (IFRS® Standards) help to reduce the differences in the way that companies draw up their financial statements in different countries.

The financial statements of limited companies are public documents, although they do not reveal details about, for example, the profitability of individual products or services sold by a company.

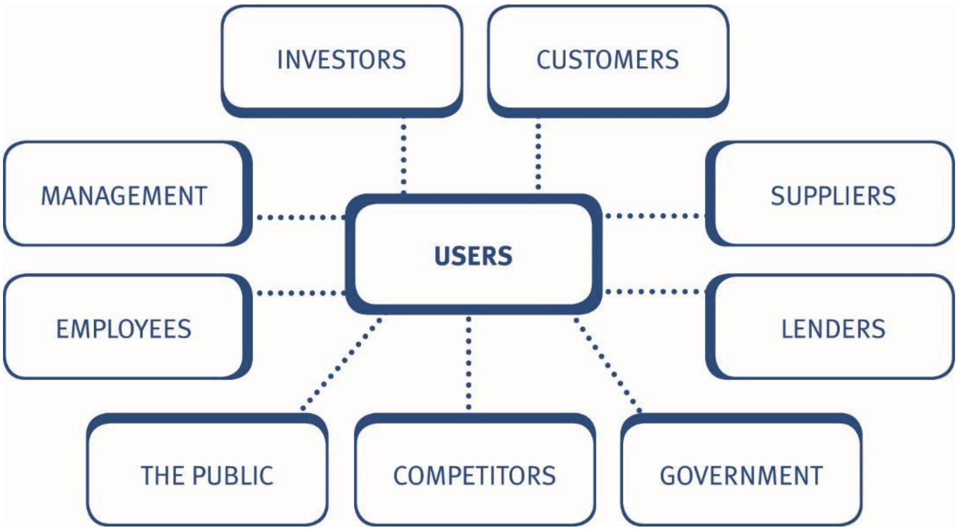
Management accounting

Management require much more detailed and up-to-date information in order to control the entity and plan for the future. Management needs to be able to cost-out products and production methods, assess profitability and so on. In order to facilitate this, management accounts present information in any way that may be useful to management, for example by operating unit or product line.

Management accounting is an integral part of management activity concerned with identifying, presenting and interpreting information used for:

- formulating strategy
- planning and controlling activities
- decision making, and
- optimising the use of resources.

2 Users of financial statements



The main users (stakeholders) of financial statements are commonly grouped as follows:

- **Investors** and potential investors are interested in the profit and returns they may receive along with the security of their investment. Future profits may be estimated from the target entity's past performance as shown in the statement of profit or loss. The security of their investment will be indicated by the financial strength and solvency of the entity as shown in the statement of financial position. The largest and most sophisticated groups of investors are the institutional investors, such as pension funds and unit trusts.
- **Employees** and trade union representatives need to know if an employer can offer secure employment and possible pay rises. They will also have a keen interest in the salaries and benefits enjoyed by senior management. Information regarding divisional profitability will also be useful if a part of the entity is threatened with closure.
- **Lenders** need to know if they will be repaid. This will depend on the solvency of the entity, which should be revealed by the statement of financial position. Long-term loans may also be backed by 'security' given by the entity over specific assets. The value of these assets will be indicated in the statement of financial position.
- **Government** agencies need to know how the economy is performing in order to plan financial and industrial policies. The tax authorities also use financial statements as a basis for assessing the amount of tax payable by an entity.
- **Suppliers** need to know if they will be paid. New suppliers may also require reassurance about the financial health of a business before agreeing to supply goods.

- **Customers** need to know that an entity can continue to supply them into the future. This is especially true if a customer is dependent on an entity for specialist supplies.
- **The public** may wish to assess the effect of the entity on the economy, local environment and local community. Companies may contribute to their local economy and community through providing employment and patronising local suppliers. Some companies also run corporate responsibility programmes through which they support the environment, economy and community by, for example, supporting recycling schemes.

Management and competitors would also use the financial statements of an entity to make economic decisions. Management, however, predominantly use management accounting information as their main source of financial information for decision-making. Competitors may also access publicly available information to assist decision-making in relation to their own business activities.

Overall, users of financial statements need information which is relevant and reliable to help them to assess management's stewardship of the resources which they control and manage. Financial information enables users to hold managers to account for their decisions and to enable users to make decisions about whether to invest in or provide additional resources to a business.

Test your understanding 1

Which of the following users do you think require the most detailed financial information to be made available to them?

A Competitors

B Management of the business

C Trade unions

D Investors

3 Types of business entity

A business can be operated in one of several ways:

Sole trader

This is the simplest form of business entity where a business is owned and operated by one individual, although it might employ any number of people. With this form of entity, there is no legal distinction between the owner and the business. To this end the owner receives all of the profits of the business but has unlimited liability for all the losses and debts of the business.

The capital structure of a sole trader is also relatively simple. There is a capital account which represents the financial interest of the owner in the business. The capital account can be added to by the owner introducing additional capital into the business, or by the business making profits, which the sole trader is entitled to. The capital account can be reduced by the sole trader making withdrawals from the capital account during the year (often referred to a 'drawings') or by the business making losses.

Partnership

Similar to a sole trader the owners of a partnership collectively receive all the profits and have unlimited liability for the losses and debts of the business. The key distinction is that there are at least two owners. The joint owners, or partners, are jointly and severally liable for the losses the business makes (i.e. they are each fully liable in respect of all business liabilities).

The capital structure of a partnership is similar to that of a sole trader. Each partner will have a financial interest in the business and this will be divided between a capital account and current account. The capital account is normally a fixed amount that will only change upon a partner joining or leaving the business. The current account includes the share of profit or loss that each partner is entitled to, less any personal drawings made by that partner.

Limited liability companies

Unlike sole traders and partnerships, a limited liability company is established as separate legal entity to their owners. This is achieved through the legal process of incorporation. The owners of the company (the shareholders) invest capital in the company in return for a shareholding that entitles them to a share of the residual assets of the company (i.e. what is left when the company is wound up or liquidated). The shareholders are not personally liable for the debts of the company and whilst they may lose their investment if the company becomes insolvent they will not have to pay the outstanding debts of the company if such a circumstance arises. Likewise, the company is not affected by the insolvency (or death) of individual shareholders. Limited liability companies are managed by a board of directors who are elected by the shareholders.

The capital structure of a limited liability company is more formalised than that of a sole trader or partnership and is illustrated within this chapter. Shareholders cannot make withdrawals or 'drawings' from the business in the way that a sole trader or partner is able to do. Instead, they receive a return on their investment in the company referred to as a dividend which is paid from accumulated profits.

Operating as a sole trader, partnership or company

Sole trader

Accounting conventions recognise the business as a separate entity from its owner. However, legally, the business and personal affairs of a sole trader are not distinguished in any way. The most important consequence of this is that a sole trader has complete unlimited liability for the debts of the entity. Business debts which cannot be paid from business assets must be met from sale of personal assets, such as a house or a car.

Sole trading entities normally operate on a small scale because they have to rely on the financial resources available to the owner.

The advantages of operating as a sole trader include flexibility and autonomy. A sole trader can manage the business as they please and can introduce or withdraw capital at any time.

Partnership

Like a sole trader, a partnership is not legally distinguished from its partners. Personal assets of the partners may have to be used to pay the debts of the partnership business. A partnership is often referred to as a firm.

The advantages of trading as a partnership stem mainly from there being many owners rather than one. This means that:

- more resources may be available, including capital, specialist knowledge, skills and ideas
- administrative expenses may be lower for a partnership than for the equivalent number of sole traders, due to economies of scale; and
- partners can substitute or act for each other to spread individual responsibilities and workloads.

Partners can introduce or withdraw capital at any time, provided that all the partners agree.

Comparison of companies to sole traders and partnerships

The fact that a company is a separate legal entity means that it is very different from a sole trader or partnership in a number of ways.

- **Property holding**

  The property of a limited liability company belongs to the company. A change in the ownership of shares in the company will have no effect on the ownership of the company's property. (In a partnership the firm's property belongs directly to the partners who are entitled to their share of each asset if they leave the partnership.)

- **Transferable shares**

  Shares in a limited company can usually be transferred without the consent of the other shareholders. In the absence of agreement to the contrary, a new partner cannot be introduced into a firm without the consent of all existing partners.

- **Suing and being sued**

  As a separate legal entity, a limited company can sue and be sued in its own name. Judgements relating to companies do not affect the members personally.

- **Security for loans**

  A company has greater scope for raising loans and may secure them with floating charges. A floating charge is a mortgage over the constantly fluctuating assets of a company providing security for the lender. It does not prevent the company using the assets in the ordinary course of business. Such a charge is useful when a company does not have non-current assets such as land, but does have significant and valuable inventories.

  Generally, the law does not permit partnerships or individuals to secure loans with a floating charge.

- **Taxation**

  Because a company is legally separated from its shareholders, it is taxed separately from its shareholders. Partners and sole traders are personally liable for income tax on their share of the profits made by their business.

- **Disadvantages of incorporation**

  The disadvantages of being a limited company arise principally from restrictions imposed by relevant company law:

  – When being formed, companies have to register and file formal constitution documents with the company registry, referred to in the UK as Registrar of Companies. Registration fees and legal costs must be paid. It is likely that many countries have a similar registration process to establish a company.

  – In addition, it is normally a requirement for a company to produce annual financial statements that must be submitted to the company registry. It is also usually a requirement for those financial statements to be audited (in some countries this is only a requirement for large and medium sized companies). The costs associated with this can be high. Partnerships and sole traders are not subject to this requirement unless it is required by a regulatory authority, such as a professional body.

  – A registered company's accounts and certain other documents are open to public inspection. The accounts of sole traders and partnerships are not open to public inspection.

  – Limited companies are subject to strict rules in connection with the introduction and withdrawal of capital and profits.

  – Members of a company may not take part in its management unless they are also directors, whereas all partners are entitled to share in management, unless the partnership agreement provides otherwise.

4 The Framework

One of the most important documents underpinning the preparation of financial statements is the *Conceptual Framework for Financial Reporting 2010* (*Conceptual Framework*), prepared by the International Accounting Standards Board (IASB) (see Chapter 2 for a discussion of the regulatory bodies).

The *Conceptual Framework* presents the main ideas, concepts and principles upon which all International Financial Reporting Standards, and therefore financial statements, are based. It includes discussion of

- the purpose of the *Conceptual Framework*
- the objectives of financial reporting
- the qualitative characteristics of useful financial information
- the definition, recognition and measurement of the elements from which the financial statements are constructed

- the accruals and going concern concepts, and
- the concepts of capital and capital maintenance (not in the syllabus).

The purpose of the Framework

The purpose of the *Conceptual Framework* is to assist the IASB in the development of financial reporting standards and to assist preparers of financial statements to develop accounting policies when reporting standards do not provide sufficient guidance, or where there is a choice of accounting policy.

It is also a useful reference document to assist in understanding and interpreting reporting standards.

The objective of financial reporting

The main objective is to provide financial information about the reporting entity to users of the financial statements that is useful in making decisions about providing economic resources to the entity, as well as other financial decisions.

Prudence

Prudence is an important concept (as referred to later in this chapter) is the exercise of caution when making judgements under conditions of uncertainty. The helps to ensure that assets and income are not overstated in the financial statements, and that liabilities and expenses are not understated.

5 Qualitative characteristics

Qualitative characteristics are the attributes that make the information provided in financial statements useful to others.

The Conceptual Framework splits qualitative characteristics into two categories:

(i) Fundamental qualitative characteristics

- Relevance
- Faithful representation

(ii) Enhancing qualitative characteristics

- Comparability
- Verifiability
- Timeliness
- Understandability

Fundamental qualitative characteristics

Relevance

Information is relevant if:

- it has the ability to influence the economic decisions of users, and
- is provided in time to influence those decisions.

Materiality has a direct impact on the relevance of information.

Qualities of relevance

Information provided by financial statements needs to be relevant.

Information that is relevant has predictive, or confirmatory, value.

- Predictive value enables users to evaluate or assess past, present or future events.
- Confirmatory value helps users to confirm or correct past evaluations and assessments.

Where choices have to be made between mutually exclusive options, the option selected should be the one that results in the relevance of the information being maximised – in other words, the one that would be of most use in taking economic decisions.

A threshold quality is one that needs to be studied before considering the other qualities of that information

- a cut-off point – if any information does not pass the test of the threshold quality, it is not material and does not need to be considered further.
- information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general purpose financial statements make on the basis of those financial statements, which provide financial information about a specific reporting entity.

Faithful representation

If information is to represent faithfully the transactions and other events that it purports to represent, they must be accounted for and presented in accordance with their substance and economic reality and not merely their legal form. This is known as 'substance over form'.

To be a perfectly faithful representation, financial information would possess the following characteristics:

Completeness

To be understandable information must contain all the necessary descriptions and explanations. This may include estimated amounts where absolute precision is neither possible nor cost-effective to achieve.

Neutrality

Information must be neutral, i.e. free from bias. Financial statements are not neutral if, by the selection or presentation of information, they influence the making of a decision or judgement in order to achieve a predetermined result or outcome.

Free from error

Information must be free from error within the bounds of materiality. A material error or an omission can cause the financial statements to be false or misleading and thus unreliable and deficient in terms of their relevance.

Free from material error does not mean perfectly accurate in all respects. For example, where an estimate has been used the amount must be described clearly and accurately as being estimate.

Enhancing qualitative characteristics

Comparability, verifiability, timeliness and understandability are qualitative characteristics that enhance the usefulness of information that is relevant and faithfully represented.

Comparability

Users must be able to:

- compare the financial statements of an entity over time to identify trends in its financial performance and financial position
- compare the financial statements of different entities to evaluate their relative financial performance and financial position.

For this to be the case there must be:

- consistency and
- disclosure.

An important implication of comparability is that users are informed of the accounting policies employed in preparation of the financial statements, any changes in those policies and the effects of such changes. Compliance with accounting standards, including the disclosure of the accounting policies used by the entity, helps to achieve comparability.

Because users wish to compare the financial position and the performance and changes in the financial position of an entity over time, it is important that the financial statements show corresponding information for the preceding periods.

Verifiability

Verification can be direct or indirect. Direct verification means verifying an amount or other representation through direct observation i.e. counting cash. Indirect verification means checking the inputs to a model, formula or other technique and recalculation of the outputs using the same methodology.

Timeliness

Timeliness means having information available to decision makers in time to be capable of influencing their decisions. Generally, the older the information is, the less useful it becomes.

Understandability

Understandability depends on:

- the way in which information is presented
- the capabilities of users.

It is assumed that users:

- have a reasonable knowledge of business and economic activities
- are willing to study the information provided with reasonable diligence.

For information to be understandable, users need to be able to perceive its significance.

6 The elements of the financial statements

In order to appropriately report the financial performance and position of a business the financial statements must summarise five key elements. The definitions are included in the Conceptual Framework and are as follows:

1 **Asset – A present economic resource controlled by the entity as a result of past events** (para 4.3).

For example, a building that is owned and controlled by a business and that is being used to house its operations and generate revenues would be classified as an asset.

2 **Liability – A present obligation of the entity to transfer an economic resource as a result of past events** (para 4.26).

For example, an unpaid tax obligation or a bank loan is a liability.

3 **Equity** – This is the 'residual interest' in the assets of the entity after deducting all liabilities. It is effectively what is returned to the owners (shareholders) when the business ceases to trade.

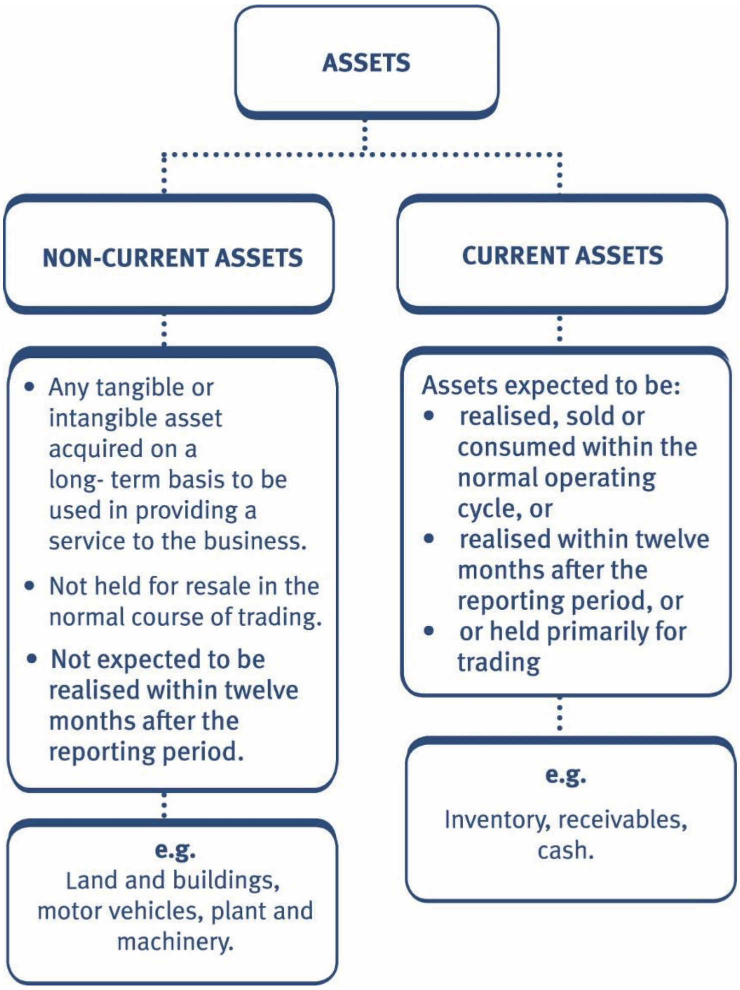
4 **Income** – This consists of the increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims. This can be achieved, for example, by earning sales revenue or through the increase in the value of an asset.

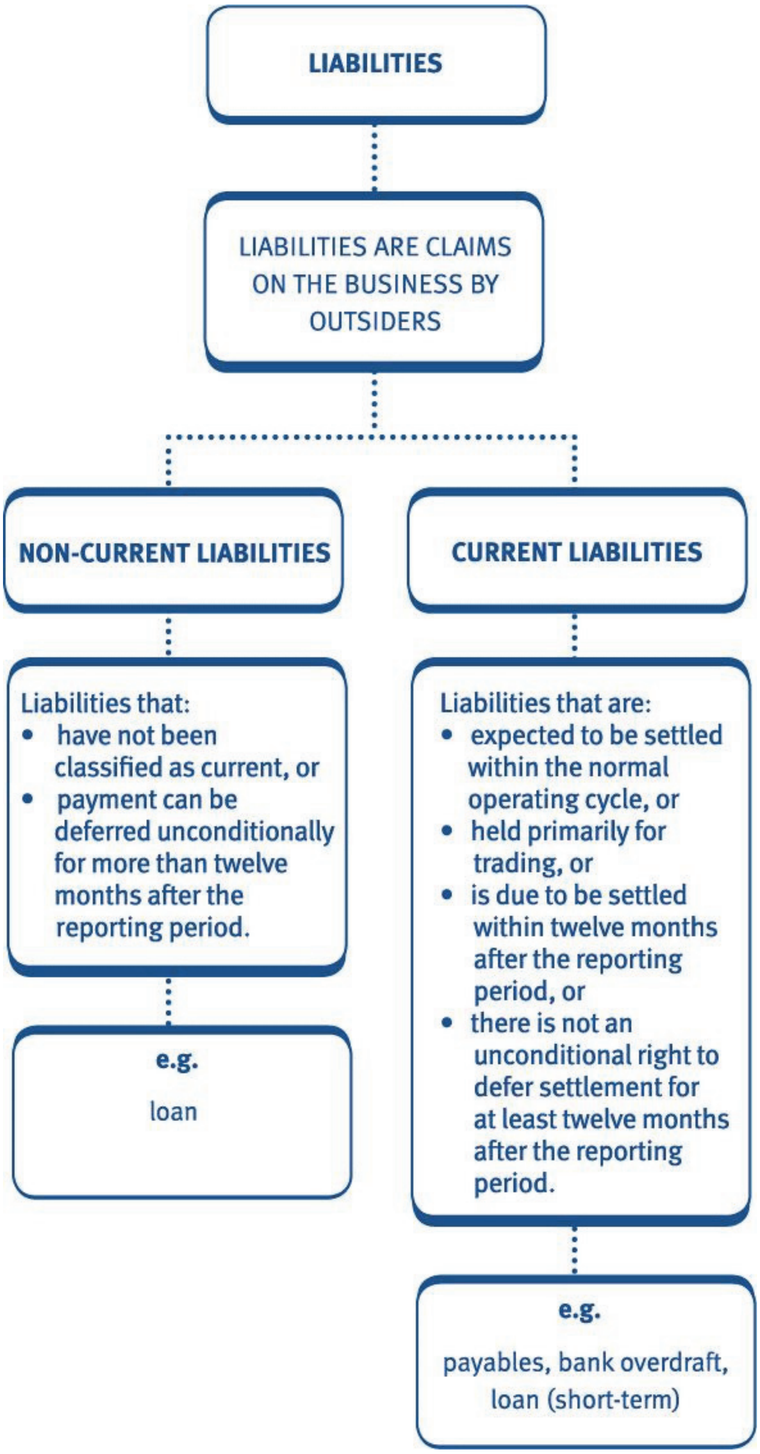
5 **Expense** – This consists of the decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims. This can be achieved, for example, by purchasing goods or services from another entity or through the reduction in value of an asset.

Note: economic resource – A right that has the potential to produce economic benefits (para 4.4). It may be thought of as anything which a business makes use of in order to produce and supply goods and services to its customers. For example, a business makes use of plant and equipment, which could be purchased or hired, to help produce goods and services.

Categorisation of assets, liabilities and equity in the financial statements

There are some additional principles with regard to the classification of assets and liabilities that relate to the length of time they will be employed in the business.




LIABILITIES
LIABILITIES ARE CLAIMS ON THE BUSINESS BY OUTSIDERS
NON-CURRENT LIABILITIES
Liabilities that:
• have not been classified as current, or
• payment can be deferred unconditionally for more than twelve months after the reporting period.
e.g.
loan
CURRENT LIABILITIES
Liabilities that are:
• expected to be settled within the normal operating cycle, or
• held primarily for trading, or
• is due to be settled within twelve months after the reporting period, or
• there is not an unconditional right to defer settlement for at least twelve months after the reporting period.
e.g.
payables, bank overdraft, loan (short-term)

Test your understanding 2
Classify the following items into current and non-current assets and liabilities: • land and buildings • receivables • cash • loan repayable in two years' time • payables • delivery van.

7 The components of a set of financial statements

A set of financial statements comprises:

- **the statement of financial position**

  This statement summarises the assets, liabilities and equity balances of the business at the end of the reporting period.

  Classification or grouping of assets, liabilities and equity in a consistent manner helps users of financial statements to understand that information and enable identification of information that is of particular relevance to them. Consistent presentation of information also helps users to make comparison and undertake analysis of financial information.

  A specimen statement of financial position, including hypothetical monetary amounts, is presented below.

Statement of financial position at 30 June 20X7

	$	$
Non-current assets		
Land and buildings		60,000
Plant and equipment		27,500
Current assets		
Inventories	11,000	
Trade receivables	10,700	
Cash at bank and in hand	1,500	
		23,200
Total assets		110,700

Equity and liabilities		
Equity share capital @ $1 shares		40,000
Share premium		2,000
Revaluation surplus		5,000
Retained earnings		43,650
Total equity at 30 June 20X7		90,650
Non-current liabilities		
6% bank loan (20X9)		10,000
Current liabilities		
Trade payables	5,000	
Bank overdraft	4,150	
Income tax liability	600	
Interest accrual	300	
		10,050
		110,700

Note that there is a standard format to the statement of financial position. Assets and liabilities have each been classified into either 'non-current' or 'current' items. Current assets are those which are expected to be converted into cash within twelve months of the reporting date. Non-current assets are those which are used in the business over a number of years to generate sales revenues and profits.

Non-current liabilities are those which will be settled more than twelve months from the reporting date. Current liabilities are those which will be settled within twelve months of the reporting date.

The capital structure of a limited liability company will be explained in more detail in the chapter ‘Capital structure and finance costs’. In the case of a sole trader, the items classified within the 'Equity' section of the statement would be replaced by a simple capital account.

- **the statement of profit or loss and other comprehensive income**

  This statement summarises the revenues earned and expenses incurred by the business throughout the reporting period. This used to be referred to as a 'profit and loss account.' A specimen statement of profit or loss and other comprehensive income, including hypothetical monetary amounts, is presented below.

Statement of profit or loss and other comprehensive income for the year ended 30 June 20X7

	$
Sales revenue	120,000
Cost of sales	(72,500)
Gross profit	47,500
Distribution costs	(10,700)
Administrative and selling expenses	(15,650)
Operating profit	21,150
Finance costs	(600)
Profit before tax	20,550
Income tax	(600)
Profit for the year	19,950
Other comprehensive income:	
Revaluation surplus in the year	2,000
Total comprehensive income for the year	21,950

Note that the statement classifies or groups expenses together based upon their function. Cost of sales, for example, may include the cost of raw materials to be converted into finished goods for sale. It may also include wages of employees directly involved in the conversion or production process. Distribution costs will include freight and delivery costs for finished goods, and may also include wages of employees involved in the distribution function. Administrative and selling costs will include the wages costs of those involved with that function, together with other related costs such as telephone and postage expenses.

Items accounted for in arriving at the profit for the year are regarded as having been realised during the accounting period.

In addition, for limited companies, there may be an additional section to the statement to recognise items of other comprehensive income. This will comprise unrealised gains and losses during the accounting period and are separately disclosed in order to arrive at total comprehensive income for the year. The most common example of other comprehensive income relevant to the ACCA FA syllabus is a revaluation surplus which arises when an entity decides to account for an increase in the value of land and buildings. This will be explained in further detail as you progress through your ACCA FA studies.

Both the profit for the year and any items of other comprehensive income are reflected in the statement of financial position and also the statement of changes in equity (see below) at the end of the accounting period.

- **the statement of changes in equity**

  This statement summarises the movement in equity balances (share capital, share premium, revaluation surplus and retained earnings – all explained in greater detail later in the text) from the beginning to the end of the reporting period. It applies only to limited liability companies and would not be required for a sole trader or partnership.

  Statement of changes in equity for the year ended 30 June 20X7

	Equity share capital	Share premium	Revaluation surplus	Retained earnings	Total
	$	$	$	$	$
Balance at 1 July 20X6	34,000	1,100	3,000	25,200	63,300
Profit for the year				19,950	19,950
Dividend paid in the year				(1,500)	(1,500)
Revaluation in the year			2,000		2,000
Issue of share capital	6,000	900			6,900
Balance at 30 June 20X7	40,000	2,000	5,000	43,650	90,650

- **the statement of cash flows**

  This statement summarises the cash paid and received throughout the reporting period. Normally, it would be relevant to limited liability companies only, rather than to sole traders and partnerships. It will be explained in the chapter 'Statement of cash flows'.

- **the notes to the financial statements**

  The notes to the financial statements comprise a statement of accounting policies and any other disclosures required to enable to the shareholders and other users of the financial statements to make informed judgements about the business. The notes to the financial statements are usually more detailed and extensive for limited liability company financial statements, than for a sole trader or partnership.

8 Important accounting principles and concepts

There are a number of other accounting principles and concepts that underpin the preparation of financial statements. The most significant ones include:

Materiality and aggregation

An item is regarded as material if its omission or misstatement is likely to change the perception or understanding of the users of that information – i.e. they may make inappropriate decisions based upon the misstated information. Note that this is a subjective assessment made by those who prepare the financial statements (usually company directors) and it requires them to consider the reliability of the financial statements for decision-making purposes by users, principally the shareholders.

For example, consider if the bank balance of a large entity (such as a company listed on the stock exchange) was misstated by $1 in the statement of financial position. This may not be regarded as a material misstatement which would significantly distort the relevance and reliability of the financial statements. However, if the bank balance was misstated by $100,000, this is more likely to be regarded as a material misstatement as it significantly distorts the information presented in the financial statements.

Aggregation of similar items is permitted as this presents summarised information of items with similar characteristics in the financial statements. For example, the total amount due from trade receivables is disclosed rather than specific amounts due from each customer.

Substance over form

As noted earlier, if information is to be presented faithfully, the economic reality must be accounted for and not just the strict legal form.

An example of substance over form that you will encounter later in the text is the accounting treatment of redeemable preference shares. Although in legal form they are shares, there is an obligation to repay the preference shareholders and so they are accounted for as debt.

Going concern

Financial statements are prepared on the assumption that the entity is a going concern, and will continue to operate for the foreseeable future (i.e. it has neither the need nor the intention to liquidate or significantly curtail its operations). The normal expectation is that, based upon current knowledge and understanding of the business, it is reasonable to assume that the business will continue to operate for the next twelve months. Note that there is no guarantee that this will always be the case as evidenced by business failures and insolvencies.

The business entity

This principle means that the financial accounting information presented in the financial statements relates only to the activities of the business and not to those of the owner. From an accounting perspective the business is treated as being separate from its owners.

Accruals basis

This means that transactions are recorded when revenues are earned and when expenses are incurred. This pays no regard to the timing of the cash payment or receipt.

For example, if a business enters into a contractual arrangement to sell goods to another entity the sale is recorded when the contractual duty has been satisfied. That is likely to be when the goods have been supplied and accepted by the customer. The payment may not be received for another month but in accounting terms the sale has taken place and should be recognised in the financial statements.

Prudence

Preparers of financial statements should exercise **prudence** when preparing financial statements. Assets and income should not be overstated whilst liabilities and expenses should not be understated. However, care must be exercised to ensure that there is not deliberate misstatement of assets, liabilities, income and expenses as that would introduce bias into the financial statements. Applying the principle of prudence helps to ensure that financial statements are fairly stated and can be relied upon by users.

Consistency

Consistency of accounting treatment and presentation relates not only from one accounting period to the next, but also within an accounting period, so that similar transactions are accounted for in the same way. Application of IFRS Standards also help to promote consistency of accounting treatment between entities as identical items are subject to the same accounting requirements. Users of the financial statements need to be able to compare the performance of an entity over a number of years and to be able to compare the financial performance and position of different entities. Therefore it is important that the presentation and classification of items in the financial statements is retained from one accounting period to the next, unless there is a change in circumstances or a requirement of a new IFRS Standard as this facilitates comparability of information in the financial statements.

Offsetting

Offsetting is netting-off transactions and balances, which results in recording or presenting only the net effect of those transactions and balances. This reduces the information available to users of financial information and is not permitted (subject to a few limited exceptions). The gross or full effect of transactions and balances should be recorded and presented in financial statements.

For example, many entities have both cash in the bank and a bank loan. They are presented separately in the financial statements (one as an asset and the other as a liability), rather than just the net balance. Similarly, if an entity both sells to, and buys from, another entity on credit terms, it may have both a receivable (amount due to it) and a payable (amount due from it) outstanding at the accounting year end. The two amounts are presented separately in the financial statements, rather than simply the net amount due to or from the entity.

Duality (dual aspect)

This principle recognises that every transaction has two effects and therefore must be recorded twice in the accounting records. It is the fundamental principle upon which double-entry bookkeeping is based and is covered in detail in the following chapters of this publication.

For example, if an entity uses a business debit card to purchase a laptop for use in the office, what is the dual effect? The entity now has new asset (a laptop) and a reduced bank balance. Both effects, the dual effect, must be recorded in the accounting records.

Historical cost and current value

Historical cost is the original monetary value of a transaction at the date that transaction was entered into. For example, an entity may have purchased a factory thirty years ago at a historical cost of, say, $100,000. It bears no relation to the current value of the factory that may now have a current value significantly in excess of its original cost due to the cumulative effect of inflation and other economic factors. Similarly, the historical cost of an item of plant and equipment may be significantly more than its current value due to factors such as wear and tear from usage and changes in technology.

Test your understanding 3

Which of the following statements are correct?

1 Only tangible assets (i.e. those with physical substance) are recognised in the financial statements.

2 Faithful representation means that the commercial effect of a transaction must always be shown in the financial statements even if this differs from legal form.

3 Application of the accruals principle means that, if an entity makes a profit, then it will not have a bank overdraft.

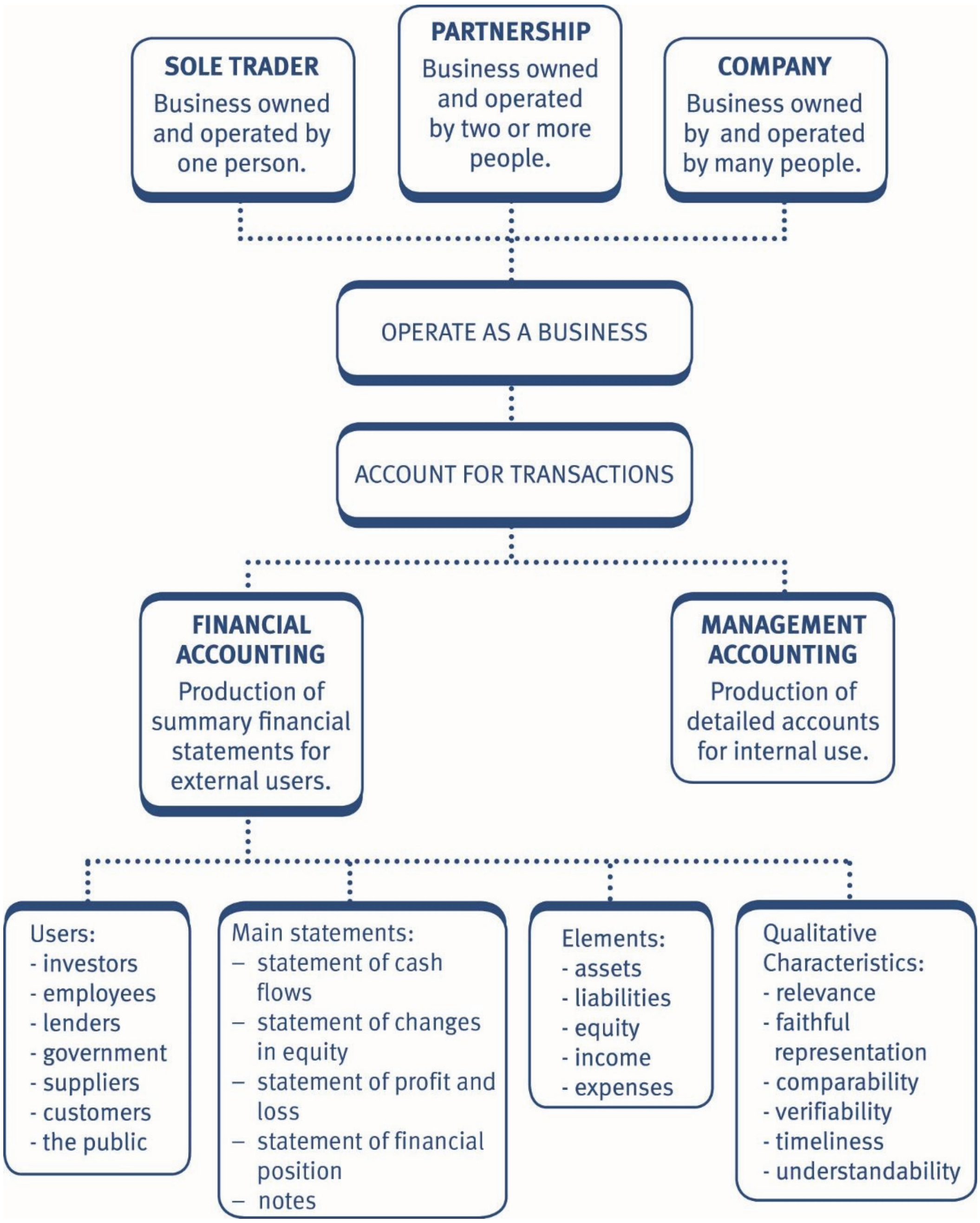
A All of them

B 1 and 2 only

C 2 only

D 2 and 3 only

9 Chapter summary



Test your understanding answers

Test your understanding 1

The correct answer is B – Management

Management need detailed information in order to control the business and make informed decisions about the future. Management information must be up-to-date and is normally produced on a monthly basis.

Other parties will need far less detail:

- Competitors will be monitoring what the competition are currently planning and working on.
- Trade unions will only require information which relates to their job role. They will only be particularly interested in disputes.
- Investors are interested in profitability and the security of their investment.

Test your understanding 2

- Land and buildings – **non-current asset**.
- Receivables – **current asset**.
- Cash – **current asset**.
- Loan repayable in two years' time – **non-current liability**.
- Payables – **current liability**.
- Delivery van – **non-current asset**.

Test your understanding 3

The correct answer is C

Both tangible and intangible assets may be recognised as long as they meet the definition of an asset.

Faithful representation includes the concept that transactions should reflect their economic substance, rather than the legal form of the transaction.

Application of the accruals principle means that transactions and events are recorded when they occur, which is not necessarily the same time as cash receipts and payments occur. For example, if goods are sold on credit, the sale is recorded when the goods are supplied, whereas the cash receipt will be recorded at a later date when it is received.

Chapter

2

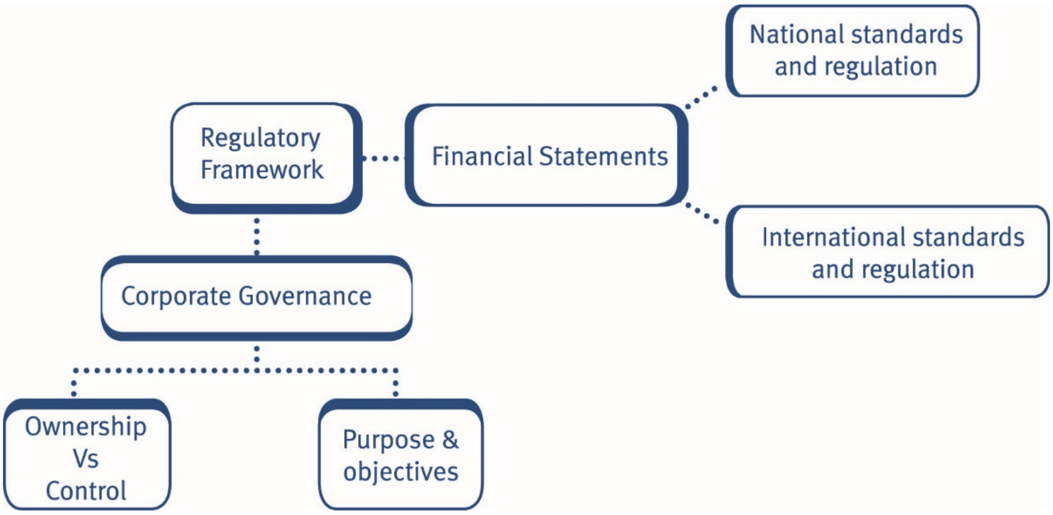
The regulatory framework

Chapter learning objectives

Upon completion of this chapter you will be able to:

- explain the purpose of the financial reporting regulatory system
- explain the role of IFRS Standards
- explain what is meant by corporate governance, and
- describe the duties and responsibilities of company directors.

1 Overview



Introduction

This chapter provides the underpinning knowledge to enable you to understand the regulatory framework, and its importance to financial reporting.

The content of this chapter is an important foundation for your future ACCA studies, in particular for Financial Reporting and Strategic Business Reporting.

2 The regulatory framework

Why a regulatory framework is necessary

A regulatory framework for the preparation of financial statements is necessary for a number of reasons:

- to ensure that the needs of the users of financial statements are met with at least a basic minimum of information
- to ensure that all the information provided in the relevant economic arena is both comparable and consistent. Given the growth in multinational companies and global investment this arena is an increasingly international one
- to increase users' confidence in the financial reporting process
- to regulate the behaviour of companies and directors towards their investors.

Accounting standards on their own would not be sufficient to achieve these aims. In addition, there must be some legal and financial market-based regulation.

National regulatory frameworks for financial reporting

There are many elements to the regulatory environment of accounting. A typical regulatory structure includes:

- national financial reporting standards
- national law
- market regulations
- security exchange rules.

For example the UK has the Financial Reporting Council that issues financial reporting standards in the UK. The main item of legislation affecting businesses in the UK is the Companies Act 2006. However, there are also many other pieces of UK, EU and even US legislation (the Sarbanes Oxley Act) that affect accountability in the UK. There are also industry-specific regulators that affect accounting in the UK, for example, the Financial Conduct Authority, who aims to ensure that financial markets work well for individuals, businesses and the economy as a whole. Finally, there are regulations published by the London Stock Exchange for companies whose shares are quoted on this market.

3 IFRS Standards

Due to the increasingly global nature of investment and business operation there has been a move towards the 'internationalisation' of financial reporting. This 'harmonisation' was considered necessary to provide consistent and comparable information to an increasingly global audience.

If companies use different methods of accounting, then before any decisions can be made about different entities the accounts would have to be rewritten, so that the accounting concepts and principles applied are the same. Only then could relevant comparisons be made.

Harmonisation illustration

To illustrate the importance of harmonisation, do some research on the internet for words that have totally different meanings in different countries. When you have done this, you will undoubtedly have a much better appreciation of the benefits of a harmonised approach to information that will be available in an international arena.

Your research may also help you avoid some very embarrassing predicaments in the future!

IFRS Standards are not enforceable in any country. As we will see shortly, they are developed by an international organisation that has no international authority. To become enforceable they must be adopted by a country's national financial reporting standard setter.

Within the European Union, IFRS Standards were adopted for all listed entities in 2005. Other countries to adopt IFRS Standards include: Argentina, Australia, Brazil, Canada, Russia, Mexico, Saudi Arabia and South Africa. The US, China and India are going through a process of 'convergence,' whereby they are updating their national standards over time to become consistent with IFRS Standards.

4 Structure of the international regulatory system

IFRS Foundation (the Foundation)

The Foundation is the supervisory body for the IASB® and is responsible for governance issues and ensuring that each member body is properly funded. It consists of a monitoring board which deals with public accountability and a board of trustees that has responsibility for governance, strategy and oversight of activities.

The principal objectives of the Foundation are to:

- develop a set of high quality, understandable, enforceable and globally accepted financial reporting standards
- promote the use and rigorous application of those standards
- to take account of the financial reporting needs of emerging economies and small and medium sized entities
- bring about the convergence of national and international financial reporting standards.

International Accounting Standards Board (the Board)

The Board is the independent standard setting body of the Foundation. Its members are responsible for the development and publication of IFRS Standards and interpretations developed by the Interpretations Committee (IFRIC® Interpretations). Upon its creation the Board also adopted all existing International Accounting Standards (IAS® Standards).

Many national standard setting bodies are represented on the Board and their views are taken into account so that a consensus can be reached. National standard setters can issue discussion papers and exposure drafts issued by the Board for comment in their own countries, so that the views of preparers and users of financial statements can be represented. A major national standard setter normally takes the 'lead' on international standard-setting projects.

IFRS Interpretations Committee (IFRIC®)

The IFRIC reviews widespread accounting issues (in the context of IFRS Standards) on a timely basis and provides authoritative guidance on these issues (IFRIC Interpretations®). Their meetings are open to the public and, similar to the Board they work closely with national standard setters.

IFRS Advisory Council (The Council)

The Council is the formal advisory body to the Board and the Foundation. It is comprised of a wide range of members who are affected by the Board's work. Their objectives include:

- advising the Board on agenda decisions and priorities in the their work,
- informing the Board of the views of the Council with regard to major standard-setting projects, and
- giving other advice to the Board or to the Trustees.

Development of an IFRS Standard

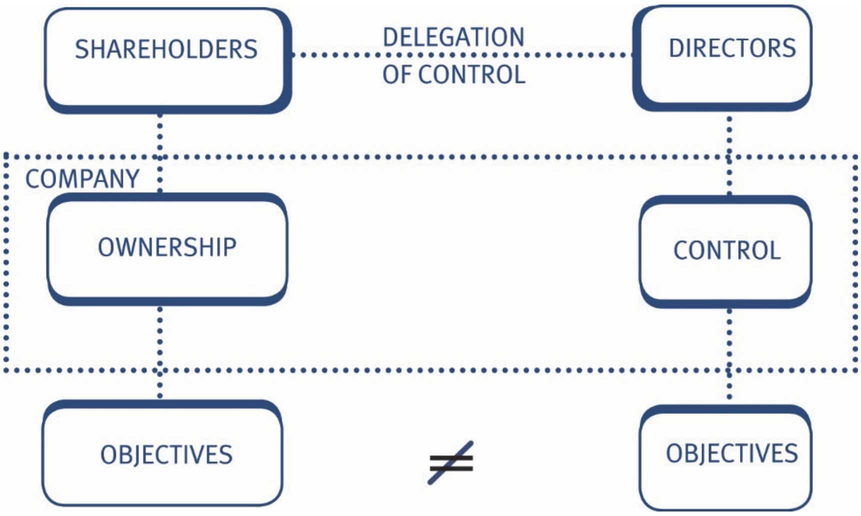
The procedure for the development of an IFRS Standard is as follows:

- The Board identifies a subject and appoints an advisory committee to advise on the issues.
- The Board publishes an exposure draft for public comment, being a draft version of the intended standard.
- Following the consideration of comments received on the draft, the Board publishes the final text of the standard.
- At any stage the Board may issue a discussion paper to encourage comment.
- The publication of an IFRS Standard, exposure draft or IFRIC interpretation requires the votes of at least eight of the 15 Board members.

International Sustainability Standards Board (ISSB)

The ISSB was formed in 2021 with the objective of delivering a comprehensive global baseline of sustainability-related disclosure standards. This should provide relevant information to investors and other interested parties to help them make informed decisions concerning sustainability-related risks and opportunities relevant to individual companies.

5 Company ownership and control



A company is a corporate body that has registered in accordance with the requirements of relevant national company law (e.g. the Companies Act 2006 in the UK), thus becoming a legal entity. Ownership of the company is evidenced by the issuing of shares to the owners (i.e. the shareholders).

For some smaller and medium-sized companies the owners may also be the directors/managers of that company. It is also possible for directors of large, publicly-listed companies to own shares in the companies they work for. However, of the largest 100 UK companies, directors typically own less than 1% of the shares of the company they work for.

Typically large, listed companies are owned by a wide range of individuals and organisations, such as pension funds, trusts and investment banks. These individuals and entities will not have any involvement in the day-to-day running of the business. Imagine if you had to organise a meeting of all shareholders every time the business needed to make a decision such as the hiring of a new member of staff or which leasing company to rent cars from. It would take far too long to make these decisions and consensus amongst such a large group might be difficult to achieve.

Instead, directors are appointed to manage the business on behalf of the owners. This leads to the separation of ownership and control within the company. Unfortunately the objectives of owners and directors often conflict. Whilst they might both have the objective of increasing their own personal wealth, if the directors increase their own salaries and bonuses this reduces the profit available to the shareholders. Also, the directors will be rewarded for the financial success of the business, which leads towards a risk that bias may be introduced in the preparation of the financial statements. This could ultimately result in a reduction in reliability/credibility of the financial statements.

The current financial reporting environment

Recent history has been dogged with examples of unreliable, and often fraudulent, financial reporting, where directors or senior managers have put their own personal interests above those of the shareholders. Enron, Lehman Brothers, WorldCom, Parmalat and Wells Fargo are high profile examples where accounting misstatements (deliberate or otherwise) have resulted in the publication of unreliable financial statements which has misled shareholders, often with very significant personal gain to the perpetrators..

These cases only serve to exacerbate the problem of shareholder confidence, creating a culture of mistrust of directors (and auditors) of large companies. This has sadly led to a loss of credibility in published financial reports. Whilst the various regulators around the world have responded, not least with the move to harmonise both financial reporting and auditing, there is still a long way to go in the fight to restore credibility to financial statements.

6 What is 'corporate governance'?

The **Cadbury Report 1992** provides a useful definition:

> 'the system by which companies are directed and controlled'.

An appropriate expansion to this definition might include:

> 'in the interests of shareholders and in relation to those stakeholders beyond the company boundaries'.

The use of the term stakeholders suggests that companies (and therefore their management team) have a much broader responsibility to the economy and society at large. This includes concepts such as public duty and corporate social responsibility.

If directors of a company have a responsibility to these groups then they must also be held accountable to them.

7 Purpose and objectives of corporate governance

The basic purpose of corporate governance is to monitor those parties within a company who control the resources and assets of the owners.

The primary objective of sound corporate governance is to contribute to improved corporate performance and accountability in creating long-term shareholder value.

The need for corporate governance

Simply put, if the stock market mechanism is to succeed then there needs to be a system that ensures publicly-owned companies are run in the interests of the shareholders and that provides adequate accountability of the people managing those companies. Note that there is an ongoing requirement to review and update corporate governance guidance to ensure that it remains relevant to current business and commercial practices.

The basic elements of sound corporate governance include:

- effective management
- effective systems of internal control
- oversight of management by non-executive directors
- fair appraisal of director performance
- fair remuneration of directors
- fair financial reporting, and
- constructive relationships with shareholders.

In order to be accountable to the stakeholders of the business the directors of a company have a range of duties such as:

- a general duty of care to act in good faith for the benefit of the company and its shareholders
- a duty of care to avoid a conflict of interest between personal interests and those of the company and its stakeholders, and to make disclosure if such a conflict arises.

Directors' responsibilities that are more specific are normally imposed by law or regulation in many countries and typically include the following responsibilities:

- establishing and maintaining an adequate system of internal controls which prevents and detects fraud and error
- maintaining adequate accounting records that provide a basis for the preparation of the annual financial statements
- preparing annual financial statements that show a 'true and fair' view of the financial position and performance of the company, including compliance with relevant laws, regulations and IFRS Standards
- responsibility to approve the annual financial statements prior to their publication, and to distribute or file the annual financial statements in accordance with local law and regulations.

Note that, in many countries, directors may incur civil and/or criminal sanctions if they fail to discharge their duties and responsibilities.

Example of corporate governance - I

The UK Corporate Governance Code (2018)

The UK adopts what is commonly referred to as a 'comply or explain' approach to corporate governance. All listed companies in the UK have to submit a report stating how they have complied with the provisions of the code and a statement of compliance with the code. If they have not been compliant they have to explain why they have not complied and what alternative action they have taken.

The code provides guidance on five areas of governance:

(i) board leadership and company purpose

(ii) division of responsibilities of the board of directors

(iii) composition, succession and evaluation of the board of directors

(iv) audit, risk and internal control

(v) remuneration of the board of directors.

Example of corporate governance - II

The US Sarbanes Oxley Act

In the US corporate governance is enshrined in law, meaning compliance is compulsory and failure to comply could lead to criminal conviction. The Act enforces:

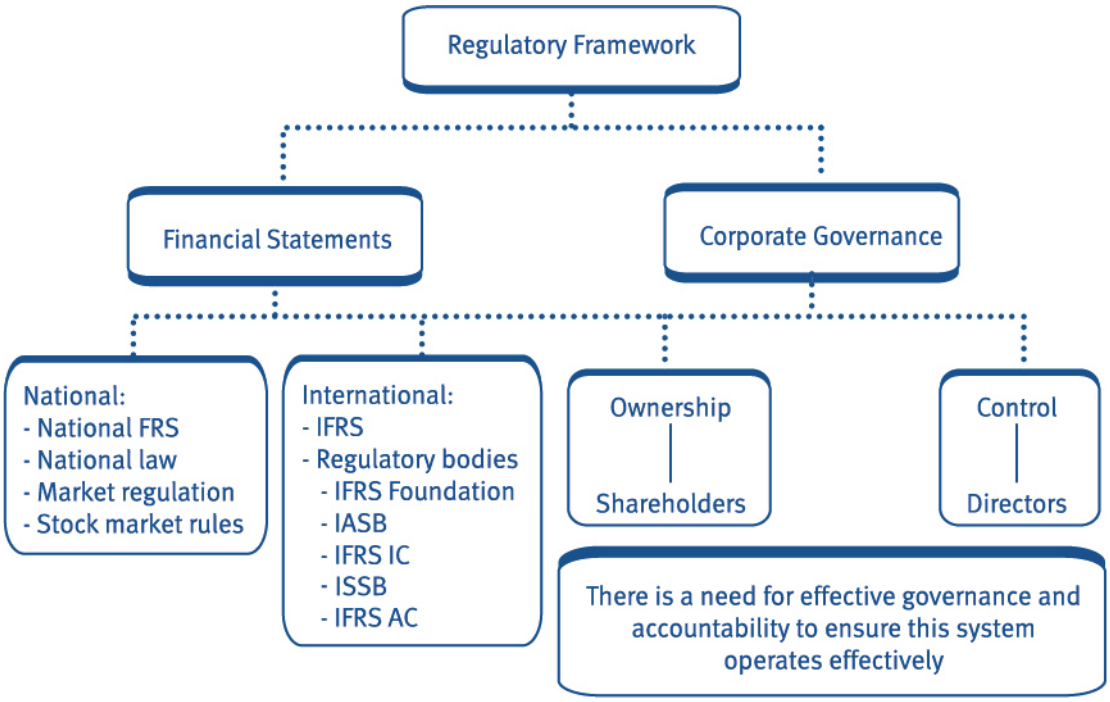
- sound systems of internal control
- clear documentation of financial processes, risks and controls
- evidence that management have evaluated the adequacy and design of systems and controls
- evidence that the auditor has evaluated the adequacy and design of systems and controls.

The fundamental aim of the Act is 'to provide the company, its management, its board and audit committee, and its owners and other stakeholders with a reasonable basis to rely on the company's financial statements.'

Test your understanding 1

Briefly describe the role of corporate governance.

8 Chapter summary



Test your understanding answers

Test your understanding 1
The role of corporate governance is to protect shareholder rights, enhance disclosure and transparency, facilitate effective functioning of the board and provide an efficient legal and regulatory enforcement framework. It is the system by which entities are directed and controlled so that, not only do they 'do the right thing' they are 'seen to be doing the right thing'. Note that there are different approaches to corporate governance. The UK has a 'principles-based' approach, whereas the US has a 'rules-based' approach.

Chapter

3

Double-entry bookkeeping

Chapter learning objectives

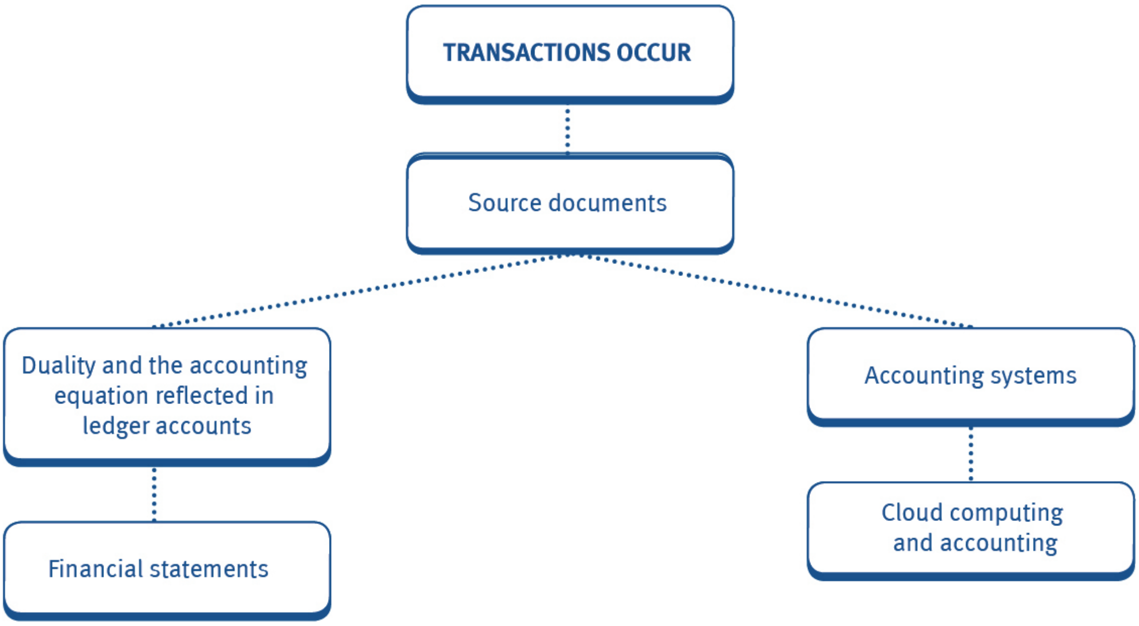
Upon completion of this chapter you will be able to:

- explain the main forms of business transactions and documentation
- understand and apply the concepts of duality, double-entry and the accounting equation
- identify, explain and understand the main forms of accounting record, including:
  - accounting records and systems
  - source documents
- explain, understand and apply ledger accounting and the use of the journal.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter introduces you to the nature of business transactions and documentation and how transactions are recorded in the accounting records.

Much of the content of this chapter is likely to be new to you. However, it is an important foundation for your future ACCA studies, particularly Financial Reporting.

2 Business transactions and documentation

In every business, transactions and events usually take place on a daily basis. The role of financial accounting and reporting is to measure the effects of those transactions and events, record the effect on the business and summarise those transactions and their consequences in a format that is useful to the users of the financial statements.

Business transactions that take place include the sale of goods and/or services to customers, the purchase of goods and/or services from suppliers, and payroll related transactions. Other business transactions include bank receipts and payments, the raising and repayment of finance and tax payments. All of these transactions must be recorded, classified and summarised in the financial accounting and reporting system.

With most transactions a source document will be created to confirm that the transaction did take place, where and when the transaction took place and the monetary value of the transaction. This documentation is vital to the financial accountant, who uses it as a data source to initiate the measurement and recording of transactions.

The table below summarises the principal business documentation and data sources for an accounting system, together with their contents and purpose.

	Contents	**Purpose**
Quotation	Quantity and description of goods required.	To establish the price from various suppliers and cross-refer to purchase requisition.
Purchase requisition	Name of the requestor, date of request, details and reason for goods or services requested. It may also include suggested supplier and cost.	Completed by an employee to request the purchase of goods or services by the entity. It must be approved by a responsible person to generate a purchase order. If a quotation has been received, that detail would also be included.
Purchase order	Details of supplier, e.g. name and address. Quantity, price and description of goods required. Terms and conditions of delivery, payment, etc.	Sent to supplier as a request to supply based upon details from the purchase requisition. When goods are subsequently received, this information will be checked against the supplier despatch note and invoice to ensure that the correct goods, quantity and price are as expected.
Sales order	Quantity/description/details of goods required by a customer including price and other criteria e.g. date required.	Generated by the supplier and, when received, will be cross-checked with the purchase order placed by the customer. Sent to the stores/warehouse department for processing.
Despatch note (goods despatched note – GDN)	Details of supplier, e.g. name and address. Quantity and description of goods despatched by the supplier.	Issued by the supplier. Checked by customer against goods received and purchase order.
Goods received note (GRN)	Quantity and description of goods received by the customer.	Produced by the customer as proof of receipt. Matched with despatch note and purchase order.
Sales invoice	Name and address of supplier and customer; details of goods, e.g. product, quantity, price, value, sales tax, terms of payment, etc.	Issued by the supplier of goods as a request for payment. This will usually be in a standard format and sequentially numbered.

Purchase (supplier) invoice	Name and address of supplier and customer; details of goods, e.g. product, quantity, price, sales tax, credit terms, etc.	Received by the customer as a request for payment from the supplier. The customer may allocate a sequential number to each purchase invoice received to aid recording and tracing of transactions.
Supplier statement	Details of supplier, e.g. name and address. Includes details of date, invoice numbers and values, payments made by customer, refunds, amount owing.	Issued by the supplier to the customer. It summarises transactions recorded by the supplier in the previous month. The customer can use this to check against other documents to ensure that the amount demanded by the supplier is correct.
Credit note	Details of supplier, e.g. name and address. Contains details of goods returned, e.g. quantity, price, value, sales tax, terms of credit, etc.	Issued by the supplier to the customer. Checked against records of goods returned.
Debit note	Details of the supplier containing details of goods returned, e.g. quantity, price, value, sales tax, terms of credit, etc.	Produced by the customer. Cross-referenced to the credit note subsequently issued by the supplier.
Remittance advice	Raised by customer and contains details of payment made to supplier – amount, invoice number(s), account number, date, etc.	Sent to supplier with, or as notification of, payment e.g. by direct credit into supplier bank account.
Receipt	Details of payment received.	Issued by the supplier confirming the payment received.

The above is not exhaustive but based upon the documentation used by a typical entity. Not all entities will produce or require all of these documents. Some may produce alternative documentation, particularly if they operate in a services industry or deal with overseas customers and/or suppliers.

3 Duality and the accounting equation

The principles of double-entry bookkeeping require that the dual effect of a transaction is recorded. In doing so, the accounting concept of duality is applied and the accounting equation is maintained. As transactions are recorded from the perspective of the entity, rather than its owners, this approach also demonstrates application of the business entity concept.

Examples of the dual effect of transactions:

- Lee commenced business as a sole trader and paid $10,000 into a business bank account – the dual effect is:
  - the business has cash at bank $10,000, and
  - the business owes the proprietor the return of $10,000 equity/capital
- Lee paid rent of $1,000 for business premises – the dual effect is:
  - expenses increase by $1,000, and
  - cash at bank decreases by $1,000
- Lee purchased goods for resale, paying $2,500 immediately – the dual effect is:
  - purchases expense increase by $2,500, and
  - cash at bank decreases by $2,500
- Lee sold some goods to a customer for $4,000 who agreed to pay at a later date – the dual effect is:
  - receivable (amount due from customer) increases by $4,000, and
  - sales increase by $4,000

A review of the transactions above should enable you to acknowledge that each transaction has two equal and opposite impacts, 'the dual effect'. The inclusion of any transaction in the accounting records requires that the dual effect is established and, applying the principles of double-entry bookkeeping, can then be recorded in the accounting system.

The accounting equation

The accounting equation is a simple expression of the fact that, at any point in time, the assets of an entity will be equal to its liabilities plus the equity/capital, where equity or capital is the residual interest in the assets after all liabilities have been settled which is due to the owner(s) of the business. Note that, like any equation, it can be rearranged and presented in a different way as illustrated below.

ASSETS = EQUITY + LIABILITIES

ASSETS - LIABILITIES = EQUITY

Note that any gains or losses made by an entity are due to the business owner(s). Using this simplified approach, expenses incurred will reduce equity and profits or gains made will increase equity.

In effect, equity (also referred to as capital) represents the net assets of the entity. It is the net investment that the sole proprietor has in the business.

Illustration 1 – The accounting equation

The transactions of Ali's new business in its first week were as follows:

1 Commenced business with the introduction of $1,000 cash.

2 Paid $350 rent.

3 Purchased a delivery van for $400 cash.

4 Obtained a $1,000 bank loan.

5 Purchased goods for resale at a cash cost of $300.

6 Sold all of the goods purchased for $400 on credit.

Required:

Use the accounting equation to illustrate the position of the Ali's business after each transaction.

Solution to Illustration 1

1: Ali commenced business introducing $1,000 cash

The dual effect of this transaction is:

(a) the entity has $1,000 cash, an asset

(b) the entity owes the owner (Ali) $1,000 – this is capital/equity.

Assets	=	Equity	+	Liabilities
1,000		1,000		0

2: Ali paid rent $350 rent

The dual effect of this transaction is:

(a) the entity reduced cash by $350

(b) the entity incurred an expense, reducing equity by $350.

Assets	=	Equity	+	Liabilities
1,000		1,000		0
– 350		– 350		
650		650		0

3: Purchased a delivery van for $400 cash

The dual effect of this transaction is:

(a) the entity has an asset which cost $400

(b) the entity has used $400 cash

This transaction changes the form in which the assets are held.

Assets	**=**	**Equity**	**+**	**Liabilities**
650		650		0
400 – 400		0		0
650		650		0

Note that the acquisition of an asset must lead to one of the following:

- reducing another asset by a corresponding amount (as above), or
- incurring a corresponding liability, or
- increasing equity/capital (perhaps further capital introduced by the owner(s)).

4: Obtained a $1,000 bank loan

The dual effect of this transaction is:

(a) the entity has $1,000 cash

(b) the entity has a liability of $1,000 due to the bank.

Assets	**=**	**Equity**	**+**	**Liabilities**
650		650		0
1,000		0		1,000
1,650		650		1,000

5: Purchased goods for $300 cash

The purchase represents the recognition of a new asset (inventory) and a corresponding reduction in cash, so there is no change in the accounting equation, only a change in the composition of the assets. It has a reduced cash balance but now has inventory at a cost of $300.

Assets	**=**	**Equity**	**+**	**Liabilities**
1,650		650		1,000

6: Sold goods for $400 on credit

The dual effect of this transaction is:

(a) The entity has increased its assets by $400 – it should record a receivable of $400 due to the business.

(b) The entity reduced its inventory by $300 and also earned profit of $100 – this is an increase in equity.

The revenue will increase profits and will therefore increase equity in the business.

Assets	**=**	**Equity**	**+**	**Liabilities**
1,650		650		1,000
400 – 300		100		0
1,750		750		1,000

Accounting for inventory will be covered in detail in a later chapter.

e.g

Illustration 2 – The dual effect of transactions

Below is a summary of some of the most common transactions entered into by a business entity.

Transaction	Dual effect	
Purchases for cash		
Purchases on credit		
Cash sales (making profit on sale)		
Credit sales (making profit on sale)		
Obtain a bank loan		
Bank payment for wages		
Bank interest received		
Bank receipt from credit customer		
Bank payment to credit supplier		

Required:

What is the dual effect for each of the transactions?

Solution to Illustration 2

Transaction	Dual effect	
Purchases for cash	Increase inventory	Decrease cash
Purchases on credit	Increase inventory	Increase payable liability
Cash sales (making profit on sale)	Increase cash	Decrease inventory & increase equity
Credit sales (making profit on sale)	Increase receivable	Decrease inventory & increase equity
Obtain a bank loan	Increase cash	Increase liability
Bank payment for wages	Decrease cash	Decrease equity
Bank interest received	Increase cash	Increase equity
Bank receipt from credit customer	Increase cash	Decrease receivable
Bank payment to credit supplier	Decrease cash	Decrease liability

This information is a useful summary of the dual effect of transactions that can be used as a basis for recording transactions in ledger accounts. If the principle of duality is maintained, an equal value of debits and credits will be recorded. From this, the relationship between assets, liabilities and equity can be demonstrated using the accounting equation.

Test your understanding 1

Kanaka set up a new restaurant and entered into the following transactions for the week commencing 1 June 20X2:

1 Paid a personal cheque for $30,000 into a newly opened business bank account as opening equity/capital for the business.

2 Paid $2,000 rent by bank transfer.

3 Made a bank payment of $10,000 for the supply and installation of kitchen equipment and fittings.

4 Made a bank payment of $1,000 for restaurant fixtures and fittings.

5 Purchased food and drink to sell in the restaurant at a cost of $500 and agreed to pay the supplier in one month.

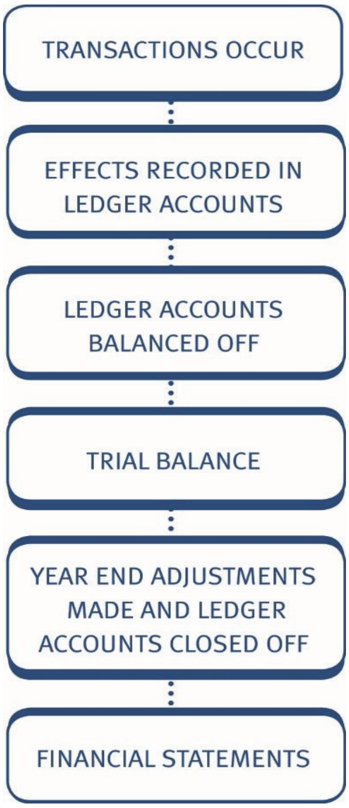
6 Received receipts from restaurant customers totalling $1,750.

Required:

Present the accounting equation after each of the transactions.

4 The process to prepare the financial statements

The following diagram summarises the process to prepare financial statements, from entering into transactions and recording those transactions in the accounting system and progressing to preparation of the annual financial statements. The recording of transactions is achieved by applying the principles of double-entry bookkeeping.



The remaining part of this chapter will focus upon recording transactions in the accounting system and, in subsequent chapters, progress to the preparation of the trial balance, making year-end adjustments and, ultimately, to preparation of the annual financial statements.

When an accounting transaction has occurred, it must be recorded in the accounting system using double-entry bookkeeping principles. This requires a source document that provides evidence or information about the transaction to be recorded. Source documents will be referenced with general ledger account names or codes, along with monetary amounts, in preparation for input into the accounting system.

Depending upon the nature of the transaction, data recorded is likely to include the following:

- transaction date
- nature of the transaction e.g. purchase on credit, cash sale or journal entry
- product quantity plus description or code
- monetary value, including any sales tax element if applicable
- any trade or early settlement discount applicable, and
- the due date of payment or credit terms.

Note that not all business documentation referred to earlier in this chapter is a source document for recording transactions in the accounting system and this will be considered in the following section. We can now move on to explain the process to record those transactions in the accounting system as a basis for preparing the useful accounting information and the annual financial statements.

5 Accounting systems

Irrespective of the size and complexity of an entity, an accounting system has three components as illustrated below.

Inputs

- Source documents include sales and purchase invoices, credit notes, payroll totals, petty cash summaries, bank summaries and journals.
- Standing data is data used repeatedly to assist with the processing of recurring or regular transactions and will include data such as price lists, wage rates, sales tax rates, customer account details and supplier account details.
- Note that not all of the business documents noted earlier in this chapter are source documents used to update the accounting system. For example, a supplier statement provides a summary of transactions recorded by a supplier within the previous month and issued to a customer, it is not a source document used by either the supplier or customer to update their respective accounting systems. Similarly, a remittance advice provides information relating to a payment made, although it is not the payment itself.

Processes

- Recording transactions, which may be done in real-time so that updating takes place at the time the transaction takes place, or batch processing at appropriate intervals e.g. daily, weekly as required.
- Calculating, classifying and summarising data, such as the monetary total of sales invoices issued during a specified period, or providing an analysis of expenses incurred during a specified period.
- Updating general ledger accounts and the ‘memorandum only’ accounting information to provide management information.

Outputs

- Trial balance and financial statements (or extracts thereof as required).
- Reports, such as aged analysis of receivables, payroll summaries and payslips, inventory usage summaries, analysis of expenses and exception reports.

Historically, this would have been a manual process to record transactions in handwritten books or ledgers. Although the components of the system have not changed, as the size and complexity of entities has increased and manual accounting systems have been replaced with computerised systems.

Source documents must be referenced or coded with the general ledger accounts to be updated as appropriate. A source document will require a minimum of two general ledger account codes. More than two general ledger codes may be required if, for example, sales tax needs to be accounted for, or a purchase invoice includes more than one item of expense and/or asset expenditure.

Useful accounting information

In addition to preparing the annual financial statements, the accounting system is also used to monitor the effectiveness of the business and to help review and conclude relevant transactions. For this reason, additional data may need to be recorded in the accounting system. This information is referred to as ‘memorandum only’ i.e. it is for management decision-making and control purposes only and does not form part of the double-entry bookkeeping system. Examples of such information include:

- individual receivables’ ledger accounts to record transactions with each credit customer,
- individual payables’ ledger accounts to record transactions with each individual credit supplier,
- inventory usage reports, and
- payroll analyses.

In the case of credit sales, credit controllers require information from the accounting system with regard to who has not settled their debts and, for that reason, who needs to be contacted to remind them that payment is now due.

Equally, for suppliers who have granted a period of credit to the entity, there is a need to review which account payables are due for payment, and how much that payment should be.

Therefore, for goods purchased or sold on credit, individual customer or supplier accounts need to be set up within the accounting system, and each will have an individual supplier or customer account code. This will normally be created using a standardised procedure, and done under the supervision of a suitably responsible person such as a senior member of the accounting department and be subject to controls and checks to ensure that it is a valid account. Note that the methods of coding source documents, along with the creation and maintenance of standing data are not part of the ACCA FA syllabus.

For the purposes of the ACCA FA syllabus and exam it is assumed that, as transactions are processed to update the general ledger, the 'memorandum only' accounting information is updated simultaneously. Consequently, this means that when 'memorandum only' accounting information is recorded, it will match exactly the information recorded in the general ledger accounts.

6 Developments in accounting systems

The initial introduction of computerised systems provided little more than the facility to have faster and more reliable summarisation and totalling of values but with limited analysis of the data input. Now, there is an extensive range of 'off-the-shelf' inexpensive accounting software packages available. One benefit of these packages is that they are developed by experienced people and therefore regarded as reliable and robust. One potential downside is that any standard package may not meet the precise information needs and requirements of an individual user. These packages are normally subject to regular software updates as the package is modified over time.

Accounting software systems have developed to meet the needs of entities, such as multi-site operations. More recent developments include the availability of integrated systems. These systems are able to handle, not only accounting data, but other systems and processes relevant to other parts of the entity which may include:

- inventory management, linked to purchasing and requisitions and also sales invoicing and despatch of finished goods
- human resource management, which may include allocation of employees to jobs or activities, request and approval of annual leave, training and development activities and appraisal records
- payroll operations to ensure that employees are paid the correct amount on the due date and linked with human resource management to ensure that new starters and leavers are managed appropriately.

Many larger entities have customised systems with software tailored to meet their particular specifications. One benefit of this is that it should meet the precise information needs of the entity. However, any customised or tailored system may be at increased risk of operational problems if not properly designed, tested, installed and operated.

In a computerised system, accounting information is more likely to be presented either in a columnar format, or perhaps by the use of +/- notation, rather than presented in T-account format. The key point to remember is that the fundamental principles of double-entry bookkeeping are maintained and applied. The only difference is the format in which the information is presented.

Some, computerised accounting systems also include an integrated bank account. Note, however, that the bank account is assumed not to be integrated into the accounting system in the ACCA FA syllabus and exam.

Cloud computing and cloud accounting

One of the most recent development in accounting software is that of cloud computing and cloud accounting.

Cloud computing – a definition

Cloud computing is access to software and data storage that is hosted on remote servers and is accessed via the internet. Cloud computing enables data and information stored to be accessed from any location at any time by multiple users provided that the user has an internet connection and can log in.

Cloud accounting – a definition

Cloud accounting is the application of cloud computing to accounting systems and processes.

Cloud accounting enables external professional service companies' access to specific parts of the system. External accountants/auditors may have access to enable them to prepare or audit the annual financial statements. A payroll bureau may have access to enable them to perform payroll-related services such as monthly wage calculations and preparation of salary slips. Some entities may allow suppliers access to their production schedules to enable suppliers to deliver materials and components to the correct location at the right time to meet production commitments.

Advantages of cloud accounting

- The entity does not have to pay for, install, manage or protect software on individual machines.
- Capacity for the cloud to store more data and to share it more easily. This will also enable the entity to easily scale up or scale down its cloud accounting capacity as circumstances change.

- It is accessed 'on demand' where and when needed which aids flexibility of working practices, particularly for entities with multiple locations and multiple employees requiring access to stored data and information.
- Easier sharing of data and information within an entity, but also with external parties who may be granted access to part of the system e.g. for customers to place an order.
- The absence of a physical server will reduce maintenance costs and the risk of physical damage.
- Disaster recovery and data security is likely to be improved. For example, loss or damage to a laptop with commercially sensitive or confidential data stored on it is a significant business risk. Cloud accounting means that the data is stored on a remote server, so loss or damage to the laptop has a reduced business impact.

Disadvantages of cloud accounting

- The entity is reliant upon the financial stability of the cloud service provider to the extent that it will continue to operate and provide the services required.
- The entity is reliant upon the cloud service provider not suffering a cyber-attack or that its servers go down for any reason.
- In common with any other system, there is a risk of unauthorised access by the server provider staff, or by those staff permitting access to unauthorised persons.
- The cloud service provider must comply with relevant regulations such as data protection. The entity will need to satisfy itself that the service provider has the necessary controls and procedures in place and can be relied upon to avoid any breach of relevant regulation.

7 Ledger accounts and the division of the general ledger

In most entities, classification and recording of each transaction is based upon the elements of the financial statements (asset, liability, income, expense and equity) and is allocated to specific ledger accounts. For example, there will be a separate ledger account for sales, purchases, rent, insurance costs, asset accounts such as property, plant and equipment and amounts due from customers (receivables), liabilities to pay suppliers (payables) etc. There is no rule or limit as to how many general ledger accounts an entity should have but the system should facilitate effective and efficient accounting and control.

General ledger – a definition

The term 'general ledger' is used to refer to the complete set of ledger accounts used by an entity to record transactions. It may also be referred to as a 'nominal ledger' or 'chart of accounts'. It forms the basis of financial accounting information used to produce a trial balance and, subsequently, a set of financial statements.

Ledger account – a definition

A ledger account contains a record of transactions assigned to a specific asset, liability, item of equity, revenue or expense. It will identify increases and decreases in that item during an accounting period. Collectively, the ledger accounts contain the record of accounting entries relating to all transactions and events. They are the principal books or files for recording, summarising and totalling monetary transactions by account item or type. An entity's financial statements are generated from summary totals in the ledger accounts contained in the general ledger.

In this chapter, the focus is upon the entries made in the individual ledger accounts within the general ledger. In particular we will look at the nature of double-entry bookkeeping.

Debits and credits

Individual transactions are recorded in the relevant general ledger accounts using double-entry bookkeeping to reflect the duality concept explained previously. Each element of the financial statements may have more than one general ledger account. For example, expenses incurred may be classified into any number of headings, such as wages, purchases, insurance etc., with each having its own general ledger account. This will be supported by an appropriate general ledger coding system.

Individual general ledger accounts may simply be referred to as 'ledger accounts' or 'T-accounts'. Traditionally each account was presented as an enlarged 'T' that had two sides which, by established convention, the left-hand side and right-hand side are referred to as the debit side and credit side respectively.

An example ledger account is illustrated as follows:

Debit (Dr) | **Credit (Cr)**

Name of account e.g. Purchases, Wages

Date	Narrative	$	Date	Narrative	$

The duality concept means that each transaction will affect at least two ledger accounts. One account will be debited and the other credited. Whether an entry is made to the debit or credit side of a ledger account depends upon the type of account and the transaction. To increase an asset or an expense, the ledger account would be debited. To increase an income account or a liability, that account would be credited. This can be summarised as follows:

DEBIT (increases)	**C**REDIT (increases)
Expenses (SP&L)	**L**iabilities (SOFP)
Assets (SOFP)	**I**ncome (SP&L)
Drawings/**D**ividends (SOFP)	**C**apital/equity (SOFP)

Consequently:

- **a decrease** in an expense, asset or drawings requires a **credit** entry in that account, and
- **a decrease** in a liability, income or capital/equity requires a **debit**. Entry in that account.

You can use the mnemonic **'DEAD CLIC'** to help you remember this vitally important double-entry rule.

Summary of steps to record a transaction

1. Determine the individual ledger accounts that are affected.
2. Consider whether each account balance is being increased or decreased.
3. Decide which account should be debited or credited as applicable.
4. Check that a debit and a credit entry have been made for the same monetary amount (i.e. the entries balance).

In the ACCA FA exam, you may be presented with accounting information presented in the form of a T-account, and be asked to complete it or to identify and rectify missing or erroneous information.

e.g

Illustration 3 – The accounting entries to record transactions

Using information from an earlier illustration, a summary of some of the most common transactions entered into by a business entity are presented below.

Transaction	Debit	Credit
Purchases for cash		
Purchases on credit		
Cash sales (making profit on sale)		
Credit sales (making profit on sale)		
Obtain a bank loan		
Bank payment for wages		
Bank interest received		
Bank receipt from credit customer		
Bank payment to credit supplier		

Required:

What are the accounting entries required to record the transactions noted in the general ledger?

Solution to Illustration 3

Transaction	Debit	Credit
Purchases for cash	Purchases	Cash at bank
Purchases on credit	Purchases	Payables
Cash sales (making profit on sale)	Cash at bank	Sales
Credit sales (making profit on sale)	Receivables	Sales
Obtain a bank loan	Cash at bank	Loan liability
Bank payment for wages	Wages	Cash at bank
Bank interest received	Cash at bank	Interest received
Bank receipt from credit customer	Cash at bank	Receivables
Bank payment to credit supplier	Payables	Cash

8 The journal

The journal is a record of accounting entries made to record non-routine transactions and to correct errors. Many journal entries relate to the preparation of the annual financial statements.

Examples of transactions normally accounted for by the use of journals include the following:

- irrecoverable debts written off
- adjustments to the allowance for receivables
- accruals and prepayments
- depreciation and amortisation charges for the year
- disposals of non-current assets
- closing inventories at the end of the accounting year
- correction of errors, including the clearing of any balance on the suspense account.

A journal can be used to represent any accounting entries. In a computerised system, this is effectively what happens when transactions are posted into the general ledger. For example, when a sales invoice is raised for a credit customer, the computerised system will automatically recognise that the accounting entries required are to debit the receivables account and credit the sales account. Similarly, when a purchase invoice is process from a credit supplier, it will recognise that the accounting entries required in the general ledger are to debit purchases and credit payables.

The journal may be maintained in book form, a log or register in hard or soft copy. The key point is that a record is maintained of all accounting entries. These transactions are explained in more detail as you progress through this publication.

Journal adjustments are a clear way of setting out the required double-entry to record a transaction or adjustment in the general ledger. A brief narrative should be given to explain the accounting entries, perhaps cross-referenced to additional information or documentation.

Note that, in the ACCA FA exam, you may be required to identify or prepare the journal entry for a transaction, even though the transaction would not normally be processed in that way. It is a method of testing your knowledge and understanding of double-entry bookkeeping in an examination setting.

Presentation of a journal adjustment

An example of a journal adjustment is presented below:

<table>
<tr><td>Date</td><td>19/08/X3</td><td>Journal No. 2341</td><td>General Ledger Code Ref</td><td>$</td></tr>
<tr><td>Debit</td><td colspan="2">Irrecoverable debts written off</td><td>4231</td><td>3,000</td></tr>
<tr><td>Credit</td><td colspan="2">Receivables</td><td>7583</td><td>3,000</td></tr>
<tr><td colspan="5">To write off the amount due from DFG Co which is subject to insolvency proceedings.</td></tr>
<tr><td>Initiator: WE</td><td>Authorised: JR</td><td colspan="2">Receivables’ ledger account ref</td><td>DFG01</td></tr>
</table>

This clearly states the double-entry required, the monetary amount plus a brief explanation or cross reference to other documents evidencing the reason for the transaction. As illustrated here, the journal document may also include references to identify the initiator of the journal and the person approving or authorising the journal adjustment for processing. The use of the journal, along with examples, is covered throughout this publication.

Test your understanding 2

Kanaka set up a new restaurant and entered into the following transactions for the week commencing 1 June 20X2:

1 Paid a personal cheque for $30,000 into a newly opened business bank account as opening equity/capital for the business.

2 Paid $2,000 rent by bank transfer.

3 Made a bank payment of $10,000 for the supply and installation of kitchen equipment and fittings.

4 Made a bank payment of $1,000 for restaurant fixtures and fittings.

5 Purchased food and drink to sell in the restaurant at a cost of $500 and agreed to pay the supplier in one month.

6 Received receipts from restaurant customers totalling $1,750.

Required:

Using the information from Test your understanding 1, what are the accounting entries required to record the transactions noted in the general ledger?

Test your understanding 3

Kanaka set up a new restaurant and entered into the following transactions for the week commencing 1 June 20X2:

1 Paid a personal cheque for $30,000 into a newly opened business bank account as opening equity/capital for the business.

2 Paid $2,000 rent by bank transfer.

3 Made a bank payment of $10,000 for the supply and installation of kitchen equipment and fittings.

4 Made a bank payment of $1,000 for restaurant fixtures and fittings.

5 Purchased food and drink to sell in the restaurant at a cost of $500 and agreed to pay the supplier in one month.

6 Received receipts from restaurant customers totalling $1,750.

Required:

Using your answers from Test your understanding 2, record the transactions in the general ledger accounts (T-accounts).

9 Balancing and closing a ledger account

When all transactions for a period have been recorded, it is necessary to establish the balance on each general ledger account. In many computerised accounting systems, this will be done automatically, along with generation of a trial balance. However, it is important to understand the procedure involved and what happens to the general ledger account balances after the trial balance has been generated.

The procedure to strike a general ledger account balance is as follows:

1 Total both sides of the T-account and find the larger total.

2 Insert the larger total in the total box on both the debit and credit side.

3 Insert a balancing figure to the side of the T-account which does not currently add up to the amount in the total box. Call this balancing figure 'balance c/f' (carried forward) or 'balance c/d' (carried down).

4 Carry the balance down diagonally and call it 'balance b/f' (brought forward) or 'balance b/d' (brought down).

Illustration 4 – Balancing a general ledger account

Balance the following account:

Cash at bank

	$		$
Capital	10,000	Purchases	200
Sales	250	Rent	150
		Electricity	75
	______		______
	______		______

Solution to Illustration 4

Cash at bank

	$		$
Capital	10,000	Purchases	200
Sales	250	Rent	150
		Electricity	75
		Balance c/f	9,825
	10,250		10,250
Balance b/f	9,825		

Test your understanding 4

Balance the following account:

Cash at bank

	$		$
Capital	10,000	Purchases	1,000
Sales	300	Rent	2,500
		Electricity	750
		New van	15,000

Although this will be covered in more detail later in this publication, it is worth noting how the general ledger account balances from the trial balance will be used.

Profit or loss ledger accounts

- At the end of a period, all income and expense account balances are closed-off and used to prepare the statement of profit or loss.
- Do not show a balance c/f or balance b/f but instead put the balancing figure on the smallest side and label it ‘profit or loss'.
- The general ledger account balance will then be nil and it is then ready to be used again in the next accounting period.

Statement of financial position ledger accounts

- At the end of a period, all asset, liability and equity/capital account balances will be carried forward as the opening balances at the start of the next accounting period.
- Those balances will also be classified and arranged to prepare the statement of financial position.
- Assets/liabilities at the end of a period = Assets/liabilities at start of the next period, e.g. the bank ledger account balance at the end of one day will be the bank ledger account balance at the start of the following day.

Test your understanding 5

Nour had receivables of $4,500 at 1 January 20X5. During the year to 31 December 20X5 credit sales of $45,000 were made and cash received of $46,500 from credit customers.

Required:

What was the balance brought down on the receivables account at 31 December 20X5?

A $6,000Dr

B $6,000Cr

C $3,000Dr

D $3,000Cr

Test your understanding 6

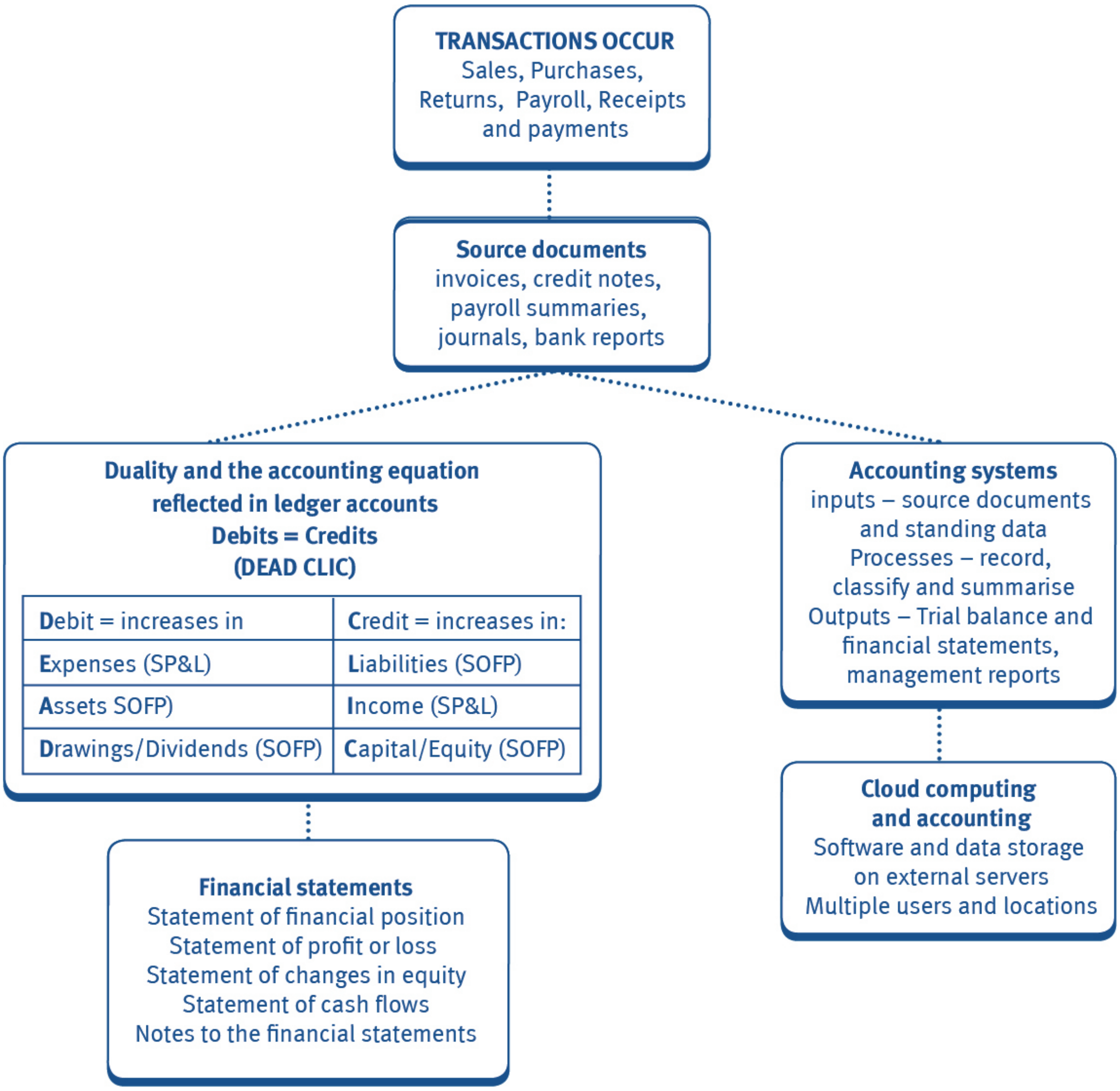
Mattie set up a trading business and in the first eight days of trading the following transactions occurred:

1 January	Mattie invested $10,000 in a new business, paying by cheque.
2 January	Mattie purchased supplies costing $4,000 and paid by cheque.
3 January	Mattie purchased a delivery van for $2,000 and paid by cheque.
4 January	Mattie purchased $1,000 of purchases on credit.
5 January	Mattie sold goods for $1,500 and received a cheque for that amount.
6 January	Mattie sold all remaining goods for $5,000 on credit.
7 January	Mattie paid $800 to the supplier by cheque.
8 January	Mattie paid rent of $200 by cheque.

Required:

Record the transactions in the general ledger accounts, close-off the income and expense accounts, and carry forward the balance on the asset, liability and equity accounts.

10 Chapter summary



Test your understanding answers

Test your understanding 1

	Remember: Assets = Equity + Liabilities Incurring an expense will reduce equity and a profit will increase equity		
Transaction	**Assets $**	**Equity/Capital $**	**Liabilities**
1 – Capital introduced	Bank 30,000	Equity 30,000	
2 – Paid rent	Bank (2,000)	Expense (2,000)	
Equation	**28,000**	**28,000**	**0**
3 – Purchase equipment	Equip't 10,000 Bank (10,000)		
Equation	**28,000**	**28,000**	**0**
4 – Purchase fixtures	Fixtures 1,000 Bank (1,000)		
	28,000	**28,000**	
5 – Purchase food etc	Inventory 500		Payable 500
Equation	**28,500**	**28,000**	**500**
6 – Cash sales	Cash 1,750 Inventory (500)	Profit 1,250	
Equation	**29,750**	**29,250**	**500**

Test your understanding 2

Transaction	**Debit**	**Credit**
1	Cash at bank $30,000	Equity/capital $30,000
2	Rent $2,000	Cash at bank $2,000
3	Fixtures and fittings $10,000	Cash at bank $10,000
4	Fixtures and fittings $1,000	Cash at bank $1,000
5	Purchases – food & drink $500	Cash at bank $500
6	Cash at bank $1,750	Sales $1,750

Note: the profit on sale of food and drink will be presented in the statement of profit or loss (not required in this exercise).

Test your understanding 3

Cash at bank

	$		$
Capital	30,000	Rent	2,000
Sales	1,750	Fixtures & fittings	10,000
		Fixtures & fittings	1,000
		Purchases	500

Equity/capital account

	$		$
		Cash at bank	30,000

Rent

	$		$
Cash at bank	2,000		

Fixtures and fittings

	$		$
Cash at bank	10,000		
Cash at bank	1,000		

Purchases

	$		$
Cash at bank	500		

Sales

	$		$
		Cash at bank	1,750

Test your understanding 4

Balance off the following account:

Cash at bank

	$		$
Capital	10,000	Purchases	1,000
Sales	300	Rent	2,500
Balance c/d	8,950	Electricity	750
		New van	15,000
	19,250		19,250
		Balance b/d	8,950

Test your understanding 5

Answer – C

Receivables

	$		$
Balance b/d	4,500	Bank	46,500
Credit sales	45,000		
		Balance c/d	3,000
	49,500		49,500
Balance b/d	3,000		

Test your understanding 6

Cash at bank

		$			$
1 Jan	Capital	10,000	2 Jan	Purchases	4,000
5 Jan	Sales	1,500	3 Jan	Delivery van	2,000
			7 Jan	Payables	800
			8 Jan	Rent	200
				Balance c/f	4,500
		11,500			11,500
	Balance b/f	4,500			

Equity/capital account

		$			$
	Balance c/f	10,000	1 Jan	Cash at bank	10,000
		10,000			10,000
				Bal b/f	10,000

Purchases

		$			$
2 Jan	Bank	4,000		To P/L	5,000
4 Jan	Payables	1,000			
		5,000			5,000

Delivery van

		$			$
3 Jan	Cash at bank	2,000		Balance c/f	2,000
		2,000			2,000
	Balance b/f	2,000			

Payables

		$			$
7 Jan	Bank	800	4 Jan	Purchases	1,000
	Balance c/f	200			
		1,000			1,000
				Balance b/f	200

Sales

		$			$
To P/L		6,500	5 Jan	Cash at bank	1,500
			6 Jan	Receivables	5,000
		6,500			6,500

Receivables

		$		$
6 Jan	Sales	5,000	Balance c/f	5,000
		5,000		5,000
	Balance b/f	5,000		

Rent

		$		$
8 Jan	Cash at bank	200	To P/L	200
		200		200

Chapter

4

Recording transactions and events

Chapter learning objectives

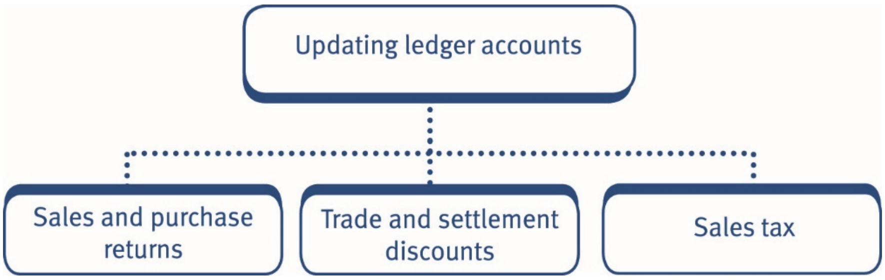
Upon completion of this chapter you will be able to:

- record cash and credit transactions
- record petty cash transactions
- record sales and purchases transactions and returns
- understand and record sales tax on transactions
- understand and record discounts allowed and received.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter continues to build upon the principles introduced in the earlier chapters. In particular, it considers accounting for sales and purchase returns, different types of discount and accounting for sales tax.

Much of the content of this chapter is likely to be new to you. However, it is an important foundation for your future ACCA studies, in particular for Financial Reporting.

2 Recording cash transactions

Cash transactions are those where payment is made or received immediately (i.e. when payment is exchanged at the point of sale/purchase). Sales and purchases made by cheque or immediate bank transfer are therefore classed as cash transactions. The main reason for this is that traditionally such transactions would be processed using a cash register or cash till. The cheques and cash in the till would be counted at the end of the day and transferred to a bank account.

Credit transactions, on the other hand, where goods are sold or purchased and paid for at a later date and, increasingly, are more commonly paid for using electronic payments methods (i.e. they are paid online) and are referred to as bank transactions.

For the sake of simplicity the following illustrations all refer to payments and receipts of cash being made out of the 'cash at bank' general ledger account, rather than distinguishing between 'bank ledger' and a 'cash ledger'.

When cash is received (i.e. increase in an asset) the entry in the cash at bank ledger account is a debit. When cash is paid out (i.e. a reduction in an asset) the entry in the cash at bank ledger account is a credit.

e.g

Illustration 1 – General ledger accounts

Show the following transactions in general ledger accounts: (Tip: The ledger accounts you need are Cash at bank, Rent, Purchases and Sales.)

1 Kamran paid $80 for rent by cheque.

2 Kamran sold goods for $230, which was banked immediately.

3 Kamran then purchased $70 of goods for resale using an immediate bank transfer.

4 Kamran sold more goods for $3,400 with customers paying by cheque.

Solution to Illustration 1

The double-entry journals for these transactions are as follows:

1 Dr: rental expenses $80, and Cr: cash at bank $80

2 Dr: cash at bank $230, and Cr: sales revenue $230

3 Dr purchases $70, and Cr: cash at bank $70

4 Dr: Cash at bank $3,400, and Cr: sales revenue $3,400

Cash at bank

	$		$
Sales (2)	230	Rent (1)	80
Sales (4)	3,400	Purchases (3)	70

Sales

	$		$
		Cash at bank (2)	230
		Cash at bank (4)	3,400

Rent

	$		$
Cash at bank (1)	80		

Purchases

	$		$
Cash at bank (3)	70		

Test your understanding 1

Afsar entered into the following transactions in the first month of trading:

1 Bought goods for cash for $380.

2 Paid $20 in sundry expenses.

3 Made sales of $1,000.

4 Received a bank loan of $5,000.

5 Paid $2,600 for fixtures and fittings.

Required:

What is the total entry to the credit side of the cash at bank ledger account?

A $6,000

B $6,380

C $3,000

D $2,620

3 Recording credit transactions

Credit sales and purchases are transactions occur when goods or services change hands immediately, but payment is not received until a future date.

Money that a business is owed by customers is accounted for in the receivables ledger (increase in an asset). Money that a business owes to suppliers is accounted for in the payables ledger (increase in a liability).

Test your understanding 2

Nat noted the following transactions that occurred in June.

1 Sold goods for cash for $60.

2 Paid insurance premium by cheque – $400.

3 Sold goods for $250 – the customer will pay in a month.

4 Paid $50 petrol for the delivery van.

5 Bought $170 goods for resale on credit.

6 Bought $57 of goods for resale, paying by cheque.

7 Bought a further $40 goods for resale, paying cash.

8 Bought a new computer for the business for $800, paying cash.

Required:

Record these transactions using ledger accounts.

Test your understanding 3

Oli entered into the following transactions:

1 Oli purchased goods for $5,000, and paid by cheque.

2 Oli made a sale to a customer for $500. The customer agreed to pay in 30 days' time.

3 Oli received a telephone bill for $40, and paid by cheque.

4 Oli received bank interest income of $150.

5 Oli purchased office stationery for $12 and paid cash.

6 Oli made a sale to a customer for $400, the customer paying immediately.

Required:

For each transaction state the two general ledger accounts affected, and which ledger account should be debited or credited.

4 Cash and petty cash transactions

Some, although not all, accounting software packages integrate the bank account as part of the software package. Note that the ACCA FA syllabus and exam assumes that the bank account is **not integrated** into the accounting system.

Recording bank transactions

Transactions that have passed through the bank account need to be included in the general ledger. This is achieved by obtaining or extracting transaction reports from the banking system, which are then used as a source document to update the general ledger accounts. Therefore, each individual receipt and payment must be referenced or coded so that it can be properly recorded in the general ledger.

In addition, receipts from credit customers will be coded with the individual receivables' ledger account reference for each customer. Similarly, payments made to suppliers relating to the payment of purchase invoices will be coded with the individual payables' ledger account code of that supplier. This enables simultaneous update of the 'memorandum only' individual payables' and receivables' accounts at the same time as the general ledger accounts.

Illustration 2 – Bank payments

Bank payments

The following is a bank payments report showing payments made from the bank account of ERT Co on 18 July 20X6, along with supporting analysis added by ERT Co.

Midshire Bank			**Bank payments report – ERT Co**			
			Analysis of payments			
Date	**Bank**	**Detail**	**Payables**	**Wages**	**Rent**	**Petty cash**
	$		$	$	$	$
18.7.X6	1,400	MRA	1,400			
18.7.X6	3,000	Office			3,000	
18.7.X6	210	MSB	210			
18.7.X6	1,600	MCS	1,600			
18.7.X6	2,400	Wages		2,400		
18.7.X6	75					75
	8,685		3,210	2,400	3,000	75

Required:

What are the accounting entries required based upon the bank payments listing?

Solution to Illustration 2

The bank account payments will be posted to the general ledger as follows:

Date 18/07/X6	**General ledger account**		**General Ledger Code Ref**	**$**
Debit	Payables		7730	3,210
Debit	Wages		4280	2,400
Debit	Rent		3005	3,000
Debit	Petty cash		8300	75
Credit	Cash at bank		8215	8,685
To record bank payments made:				
Initiator: WE	Authorised: JR	Payables' ledger account refs: MRA – M002 MSB – M007 MCS – M014		 1,400 210 1,600

Entries must also be made to the individual payables' ledger accounts of MRA, MSB and MCS respectively.

Note: general ledger account code numbers and payables' account references have been included to aid understanding.

e.g

Illustration 3 – Bank receipts

Bank receipts

The following is a bank receipts report showing receipts into the bank account of ERT Co on 18 July 20X6, along with analysis added by ERT Co.

Midshire Bank **Bank receipts report – ERT Co**

Analysis of receipts

Date	**Bank**	**Detail**	**Receivables**	**Interest**	**Sales tax**
	$		$	$	$
18.7.X6	2,400	VBN	2,400		
18.7.X6	830	Sales tax			830
18.7.X6	100	Interest		100	
18.7.X6	1,600	BNM	1,600		
18.7.X6	480	NMO	480		
	5,410		4,480	100	830

Required:

What are the accounting entries arising from the bank receipts listing?

Solution to Illustration 3

The bank account receipts will be posted to the general ledger (and individual receivables' ledger accounts as appropriate) as follows:

<table>
<tr><td>Date
18/07/X6</td><td colspan="2">General ledger account</td><td>General Ledger Code Ref</td><td>$</td></tr>
<tr><td>Debit</td><td colspan="2">Cash at bank</td><td>8215</td><td>5,410</td></tr>
<tr><td>Credit</td><td colspan="2">Receivables</td><td>5300</td><td>4,480</td></tr>
<tr><td>Credit</td><td colspan="2">Interest received</td><td>2007</td><td>100</td></tr>
<tr><td>Credit</td><td colspan="2">Sales tax receipt</td><td>8400</td><td>830</td></tr>
<tr><td colspan="5">To record bank receipts</td></tr>
<tr><td>Initiator:
WE</td><td>Authorised:
JR</td><td colspan="2">Receivables' ledger account refs:
VBN – V003
BNM – V018
NMO – V006</td><td>
2,400
1,600
480</td></tr>
</table>

Entries must also be made to the individual receivables' ledger accounts of VBN, BNM and NMO respectively.

Note: general ledger account code numbers and receivables' account references have been included to aid understanding.

Adjustments to the cash at bank general ledger account will be required for any items or transactions that appear on the bank statement but not yet included in the accounting system. Examples of such transactions include bank interest received or charged, direct debit payments, direct receipts from customers. Errors made by the bank would not be recorded in the bank general ledger account but notified to the bank for it to correct the error.

Recording petty cash transactions

Petty cash is the relatively small sums of coins and notes held by a business for the reimbursement of relatively small, out-of-pocket expenses incurred by staff on behalf of a business. Examples include the purchase of office cleaning materials, office refreshments, or to pay a taxi fare for an employee to attend a local meeting.

A business will record small cash transactions, perhaps in a book, log or similar document, for ease of maintaining a record of such transactions. As with other transactions, they need to be recorded in the general ledger. Within the general ledger, there will be a petty cash ledger account which will include receipts and payments transactions using the normal principles of double-entry bookkeeping.

Cash receipts will be recorded along with the payments which will be analysed using standard headings to assist with consistency of recording and classification of transactions. An amount is withdrawn from the bank account which is referred as a ‘petty cash float’. This ‘float’ will be used to pay for the various sundry cash expenses. The petty cash cashier will record any payments.

At any point in time the notes and coins together with the expense vouchers should agree to the total float. At the end of the period the petty cash float is ‘topped up’ by withdrawing an amount from the bank to restore the petty cash float to its normal level. This is known as the ‘imprest method’ of accounting for petty cash.

Illustration 4 – Petty cash receipts and payments

During the week ending 25 July 20X6, ERT Co recorded the following petty cash transactions with supporting analysis:

Receipts

Date	**$**	**Analysis of receipts**
18.7.X6	75	From bank

Payments — **Analysis of payments**

Date	**$**	**Detail**
19.7.X6	15	Tea & coffee
20.7.X6	13	Cleaning materials
22.7.X6	12	Rail fare
23.7.X6	21	Postage stamps
	61	

Required:

What are the accounting entries arising from the petty cash receipts and payments listings?

Solution to Illustration 4

The petty cash receipts and payments will be posted to the general ledger as follows:

Petty cash receipts:

Date 18/07/X6	**General ledger account**	**General Ledger Code Ref**	**$**
Debit	Petty cash	8300	75
Credit	Cash at bank	8215	75
To record petty cash			
Initiator: WE	Authorised: JR		

Petty cash payments:

Date 18/07/X6	**General ledger account**	**General Ledger Code Ref**	**$**
Debit	Office refreshments	8215	15
Debit	Cleaning	3100	13
Debit	Travel expenses	3250	12
Debit	Postage	3368	21
Credit	Petty cash	8300	61
To record petty cash			
Initiator: WE	Authorised: JR		

Note: general ledger account code numbers have been added to aid understanding.

5 Recording sales and purchases transactions and returns

The accounting entries required in the general ledger to record sale and purchase transactions will depend upon whether those transactions were settled immediately, or whether they were on credit. The accounting entries can be summarised as follows:

	Credit transaction	**Cash transaction**
Sales	Dr Receivables Cr Sales	Dr Cash at bank Cr Sales
Purchases	Dr Purchases Cr Payables	Dr Purchases Cr Cash at bank

It is normal for a customer to return unwanted goods to the supplier; equally a customer may have cause to return damaged or wrongly-supplied goods. The accounting entries required will depend upon whether the returned goods were initially purchased for cash or on credit as follows:

	Originally a credit transaction	**Originally a cash transaction**
Sales returns (returns inwards)	Dr Sales returns Cr Receivables	Dr Sales returns Cr Cash at bank
Purchases returns (returns outwards)	Dr Payables Cr Purchases returns	Dr Cash at bank Cr Purchases returns

Test your understanding 4

Dale entered into the following transactions:

1 Dale transferred $10,000 of personal savings into a business bank account.

2 Dale then bought goods from Lee, a supplier, for $1,000 and paid by cheque.

3 A sale was made for $400 – the customer paid by cheque.

4 Dale made a sale for $600 and the customer promised to pay at a later date.

5 Dale then bought goods from a supplier, Kamen, for $500 on credit.

6 Dale paid a telephone bill of $150 by cheque.

7 The credit customer paid the balance due on their account.

8 Dale paid Kamen $340.

9 Bank interest of $30 was received.

10 A cash customer returned $20 goods to Dale for a refund.

11 Dale returned goods which cost $100 to Kamen.

Required:

For each of the transactions noted, state the double-entry required to record the transaction in the accounting records.

6 Sales tax

Principles of sales tax

Sales tax is levied on the final consumer of a product or service. Unless it is the final consumer of the product or service then an entity that is registered to account for sales tax is essentially acting as the collection agent for the tax authority.

Sales tax is charged and paid on purchases (input tax) by suppliers and charged and collected on sales (output tax). A business registered for sales tax will effectively pay over the sales tax it has added to its sales and recover the sales tax it has paid on its purchases. To this end the business incurs no sales tax expenses and earns no sales tax income. Therefore sales tax is excluded from the reported sales and purchases.

Periodically the business will calculate the total amount of sales tax added to sales and the total sales tax added to purchases by suppliers. If output tax (on sales) exceeds input tax (on purchases), the business pays the excess to the tax authority. If input tax exceeds output tax, the business is due a refund of the excess from the tax authority.

Sales tax is sometimes referred to as value added tax (VAT) or goods and services tax. Sales tax is charged on most goods and services, although you are not expected to have any detailed or specific knowledge of which goods and services are subject to sales tax or specific tax rates.

Calculation of sales tax

Sales tax is charged at a range of rates around the world. It is also subject to different rates for different goods and services within national boundaries. To reflect this, the ACCA FA exam may examine sales tax using different tax rates. The rate will always be given to you in the question.

Commonly examinable rates include 20% (the current standard rate in the UK), 17.5% (the previous standard rate in the UK), 15% and 10%. For these rates the following price structures are relevant:

Proforma

	20%	**17.5%**	**15%**	**10%**
Net selling price (tax exclusive price)	100.0%	100.0%	100.0%	100.0%
Sales tax	20.0%	17.5%	15.0%	10.0%
Gross selling price (tax inclusive price)	120.0%	117.5%	115.0%	110.0%

- The net selling price is the amount that the business will recognise as sales income.
- The gross selling price is the price charged to customers.
- The difference between the gross and net selling price is tax collected on behalf of the tax authority which should be paid to it.

Note: You should be prepared to apply any % to the proforma above.

Illustration 5 – Calculation of sales tax

Baz sells the following goods:

1 to Ali at a tax inclusive price of $470.

2 to Les at a tax exclusive price of $700.

Required:

How much sales tax is Orlando collecting on behalf of the tax authority if the rate of sales tax is 17.5%?

Solution to Illustration 5

Sales tax can be calculated using the relevant percentage depending on whether the price is tax inclusive or exclusive.

Sales to Ali (sales price tax inclusive) (17.5%/117.5%) × $470 = $70

Sales to Les (sales price tax exclusive) (17.5%/100%) × $700 = $122.50

Total sales tax collected: $70 + $122.50 = $192.50

Test your understanding 5

Lorie purchased goods for $174,240 (including sales tax) and sold goods for $230,400 (including sales tax). The sales tax rate is 20%.

What amount of sales tax is ultimately payable to the tax authority based upon this information?

A $9,360

B $14,926

C $4,471

D $11,232

Accounting for sales tax

The usual accounting entries for purchases and sales are amended slightly when sales tax needs is accounted for, the key point being the introduction of a sales tax ledger account. This may be either a receivable or payable account balance, depending upon whether tax is payable to, or recoverable from, the tax authority.

Sales tax paid on purchases (input tax)

Dr Purchases – excluding sales tax (net cost)

Dr Sales tax (sales tax)

Cr Payables/Cash at bank – including sales tax (gross cost)

- The purchases account does not include sales tax because it is not an expense – it is recoverable from the tax authority.

- If the business makes purchases on credit, the total amount due to the supplier is split between the net purchase cost and the sales tax, with the relevant totals posted in the ledger accounts.
- If an business makes cash purchases, on which sales tax has been charged by the seller, the total amount paid must be split between the net purchase cost and the sales tax paid.
- The payables account does include sales tax, as the supplier must be paid the full amount due.

Sales tax charged on sales (output tax)

Dr Receivables/Cash at bank – sales price including sales tax (gross selling price)

Cr Sales – sales price excluding sales tax (net selling price)

Cr Sales tax (sales tax)

Key points relating to sales tax on sale transactions:

- The sales account does not include sales tax because it is not income – it is payable to the tax authority.
- If the business makes sales on credit, the total amount due from the customer is split between the net sales amount and the sales tax, with the relevant totals posted in the ledger accounts.
- If a business makes cash sales, on which sales tax has been charged, the total amount received must be split between the net sales value and the sales tax collected.
- The receivables account does include sales tax, as the customer must pay the full amount due.

Payment of output tax on sales to the tax authority

If a business charges more output tax on its sales than it suffers on its purchases, there will be a credit balance (liability) on the sales tax account. This must be paid to the tax authority and, when paid, accounted for as follows:

Dr Sales tax

Cr Cash at bank

Receipt of input tax on purchases from the tax authority

If a business suffers more input tax on its purchases than it charges on its sales, there will be a debit balance (asset) on the sales tax account. This will be refunded by the tax authority and, when received, accounted for as follows:

Dr Cash at bank

Cr Sales tax

This may arise in a given sales tax return period if, for example, an entity purchased a significant amount of plant and equipment on which sales tax had been charged by the supplier. If the entity had suffered more input tax on purchases than it had charged output tax on its own sales, then it would receive a refund of sales tax suffered from the tax authority.

Test your understanding 6

		Net	Sales tax	Total
		$	$	$
Purchases	(all on credit)	180,000	18,000	198,000
Sales	(all on credit)	260,000	26,000	286,000

Required:

Record the transactions in the general ledger accounts.

Test your understanding 7

Val's business is registered for sales tax purposes. During the quarter ending 31 March 20X6, Val made the following sales, all of which were subject to sales tax at 17.5%:

$10,000 excluding sales tax

$7,402 including sales tax

$6,745 excluding sales tax

$11,632 including sales tax.

Val also made the following purchases all of which were subject to sales tax at 17.5%:

$15,000 excluding sales tax

$12,455 including sales tax

$11,338 including sales tax

$9,870 including sales tax.

Required:

What was the balance brought down on the sales tax account as at 31 March 20X6?

A $7,639 Dr

B $1,875 Dr

C $7,639 Cr

D $1,875 Cr

Test your understanding 8

The following sales invoices were issued by Quin in July:

Date	Customer	Inv No	Ledger ref	Sales
8 July	Simpson	1100	A8	$ 411.25 (including sales tax)
10 July	Burns	1101	B5	$ 1,300 (excluding sales tax)

Quin is registered for sales tax, applied at the rate of 17.5%

Required:

What accounting entries are required to record the transactions in Quin's general ledger?

		Dr		Cr
A	Receivables	$1,711.25	Sales	$2,010.72
	Sales tax	$299.47		
B	Receivables	$2,010.72	Sales	$1,711.25
			Sales tax	$299.47
C	Receivables	$1,650.00	Sales	$1,938.75
	Sales tax	$288.75		
D	Receivables	$1,938.75	Sales	$1,650.00
			Sales tax	$288.75

7 Discounts

Trade discounts

Trade discounts are given by a supplier to try and increase the volume of sales made and to encourage customer loyalty. By reducing the unit price, buying items in bulk then becomes more attractive to potential customers. If you are able to source your products cheaper, you can then either earn extra profit on each item you sell, or you can reduce your selling price to make your goods more commercially attractive to your own customers. For example, if you were to buy over 1,000 units of a product, the supplier may reduce the unit price of those items by, say, 5%.

Accounting for trade discounts

From an accounting perspective, trade discounts are deducted at the point of sale. When accounting for a sale that is subject to a trade discount – it is the net amount that should be recorded i.e. after the trade discount has been deducted.

Test your understanding 9
Oli sold goods with a list price of $1,000 to Sam, who paid immediately, and allowed a trade discount of 10%. **Show how the above should be recorded in both the books of Oli and Sam.**

Settlement discounts

This type of discount encourages credit customers to pay for goods and services purchased quicker than they may otherwise do. If you pay for the goods within a set time limit, then you will receive a percentage discount. This may be referred to as a 'cash discount', or as an 'early settlement discount' or as a 'prompt payment discount'. For example, a cash discount of 3% may be offered to any credit customers who pay within ten days, when the normal credit terms of business are, say, thirty days.

Whilst offering this discount may encourage earlier receipt of cash from credit customers, there is still a loss of revenue to the entity which offers such a discount.

Accounting for settlement discounts

An entity may receive a discount from its suppliers – known as **Discount received.** The reduction in the payment to the supplier ('discount received') will be noted at the time the payment is made. When the payment is recorded in the general ledger accounts, discount received will be recorded as follows:

Debit: Payables (to reduce the total liability due to the supplier)

Credit: Discount received

Credit: Cash at bank

When preparing the final accounts, discount received is normally netted off against the purchases expense to reduce cost of sales.

An entity may give its customers a discount – known as **Discount allowed**. This is a reduction in revenue.

A settlement discount is different in nature to a trade discount. A trade discount is a definite reduction in price that is given to the customer. A settlement discount is a reduction in the overall invoice price that is offered to the customer. It is for the customer to decide whether to accept this discount and pay the reduced amount within the required timescale, or whether to pay the full invoice amount at a later date.

In practical terms, if a settlement discount is offered to a credit customer, there is no way of knowing at the point when the sales invoice is prepared, whether the customer will take advantage of the discount terms offered and pay the reduced amount. This is known as 'variable consideration' as the seller does not know at the time sales revenue is recorded whether the business will receive only the discounted amount or the full amount.

Variable consideration is dealt with as part of the 5-step approach to revenue recognition from IFRS 15 'Revenue from Contracts with Customers' and which is considered in more detail in the chapter 'Preparing basic financial statements'.

In practice, an entity should adopt one of the following approaches to deal with this situation depending upon whether it expects the customer to take advantage of the discount:

- prepare the sales invoice for the full amount if the customer **is not** expected to pay early and claim the settlement discount. If, as expected, the customer does not pay early, the full amount is due as normal, or
- prepare the invoice for the reduced amount (after applying the settlement discount) if the customer **is** expected to pay early and will be entitled to the settlement discount. Subsequently, if the customer does not pay early and is no longer entitled to the discount, the full amount is due and the additional amount received is treated as revenue arising from the original sales transaction, or
- the entity could raise a further invoice for the discount not taken.

Seller perspective

Therefore, **in examination questions**, when dealing with transactions from the perspective of the seller, it will be stated whether or not a credit customer is expected to take advantage of settlement discount terms for the purpose of calculating amounts invoiced and due from a customer, and to account for the subsequent receipt in settlement from the customer. The practical consequence of this approach is that settlement discount allowed is no longer recorded separately as an expense.

The following illustration shows the accounting requirements relating to settlement discounts from the perspective of the seller.

Illustration 6 – Settlement discount – seller perspective

An entity sold goods to a customer on credit at a price of $200, and the customer was offered 3% settlement discount for settlement within ten days of the invoice date.

How should this be accounted for in the books of the seller if:

(a) the customer was not expected to take advantage of the early settlement discount terms offered?

(b) the customer was expected to take advantage of the early settlement discount terms offered?

Solution to Illustration 6

(a) The customer was not expected to take advantage of the early settlement discount

The invoice would consist of the following amounts:

	$
List price	200
Less: 3% settlement discount	Nil
Amount due from customer	200

If, as expected, the customer did not take advantage of the settlement discount available, the full amount of $200 should be paid by the customer. Upon receipt of the amount due, this would be recorded as follows:

	$
Debit: Cash at bank	200
Credit: Receivables	200

If, however, the customer did take advantage of the settlement discount terms, they would pay $194. The receivable of $200 must be cleared, even though only $194 has been received in full settlement. This would be recorded as follows:

	$
Debit: Cash at bank (97% of $200.00)	194
Debit: Revenue	6
Credit: Receivables	200

(b) The customer was expected to take advantage of the early settlement discount

The invoice would consist of the following amounts:

	$
List price	200
Less: 3% settlement discount	(6)
Amount due from customer	194

In this situation, settlement discount allowed is excluded from the accounting records in the same way as trade discount is excluded from the accounting records. If, as expected, the customer paid within ten days to take advantage of the early settlement terms, the receipt would be recorded as follows:

	$
Debit: Cash at bank	194
Credit: Receivables	194

If, however, the customer did not take advantage of the early settlement terms, the full amount of $200 would be due. When received, the 'additional' receipt' would be accounted for as if it was a cash sale as follows:

	$
Debit: Cash at bank	200
Credit: Receivables	194
Credit: Revenue	6

Purchaser perspective

In examination questions, when dealing with transactions from the perspective of the purchaser, the purchaser will initially record the full cost of the goods and will then decide whether or not to take advantage of settlement discount terms offered by the seller. If advantage of the settlement discount is not taken, the gross amount is payable to the seller. If advantage is taken of the settlement discount terms offered, discount received should be recorded in the general ledger at the time the payment is recorded in the general ledger as follows:

Debit: Payables

Credit: Cash at bank

Credit: Discount received

The following illustration considers the same information as used in Illustration 1 from the perspective of the purchaser.

Illustration 7 – Settlement discount – purchaser perspective

An entity sold goods to a customer on credit at a price of $200, and the customer was offered 3% settlement discount for settlement within ten days of the invoice date.

How should this be accounted for in the books of the purchaser?

State the net cost of the goods purchased.

Solution to Illustration 7

The purchaser would initially record the purchase of goods as follows:

	$
Debit Purchases	200
Credit Payables	200

If the invoice was paid after the early settlement period, the full amount would be payable to the supplier, with the payment recorded as follows:

	$
Debit Payables	200
Credit Cash at bank	200

Alternatively, if the invoice was paid within the 10-day early settlement period, $194 would be paid to the supplier in full settlement of the amount due, and discount received for $6 would be recorded as follows:

	$
Debit Payables	200
Credit Cash at bank	194
Credit Discount received	6

The net cost of the goods purchased is $194 ($200 – $6).

Test your understanding 10

Georgie owes a supplier, Razan, $2,000. Razan has offered Georgie a cash discount for payment within ten days.

Georgie is owed $3,400 by a customer, Uli. Georgie offers a cash discount to customers of 2.5% if Uli pays within 14 days.

Georgie took advantage of the early settlement discount offered by Razan and made payment within ten days.

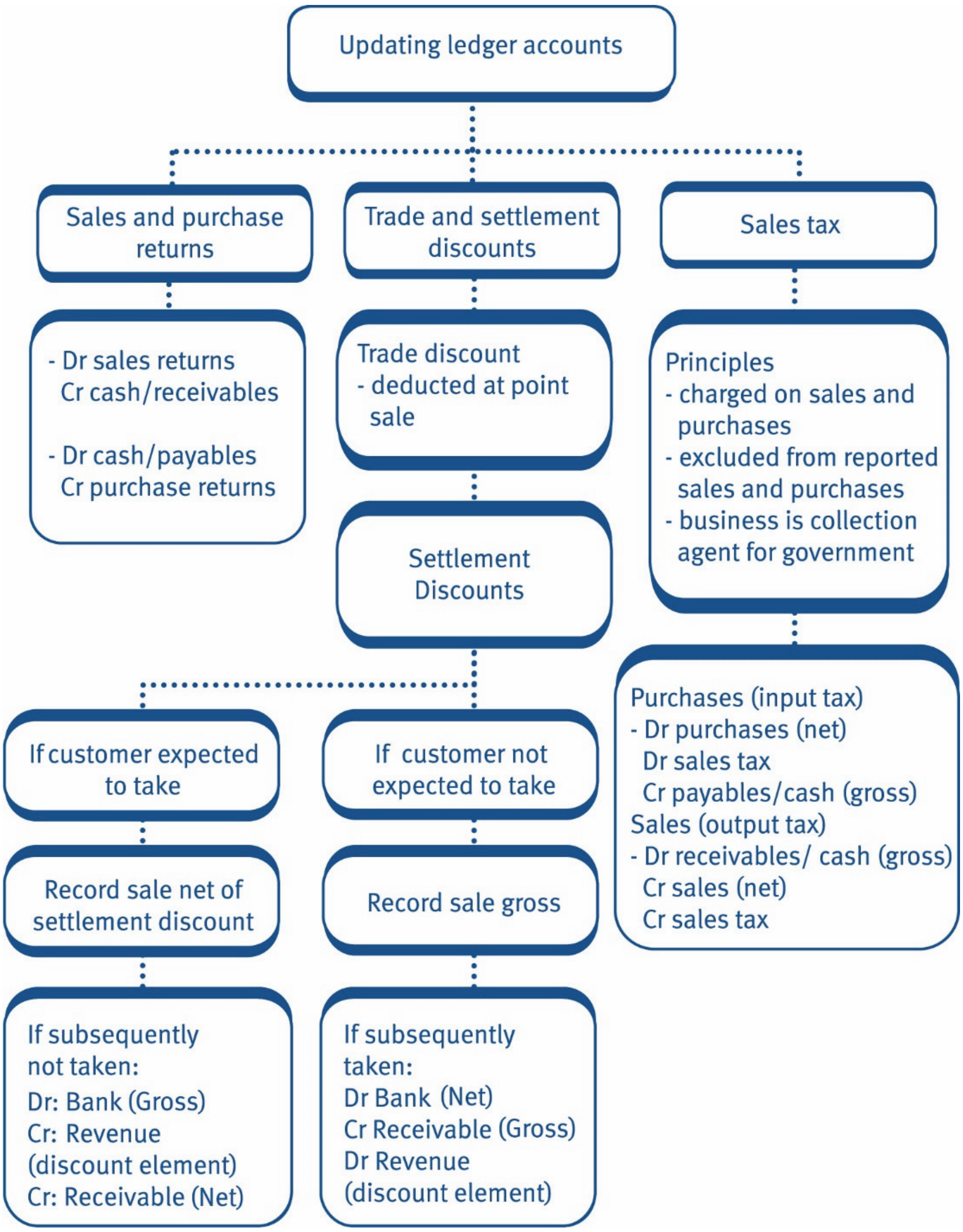
Uli was expected to take advantage of the early settlement discount offered, and therefore the sales invoice raised by Georgie was prepared on that basis. However, Uli did not pay within 14 days and paid the full amount due after 30 days.

Required:

(a) **What ledger entries are required to record the payment by Georgie to Razan, along with calculation of the net cost of the goods purchased?**

(b) **What accounting entries are required by Georgie to record the receipt from Uli?**

8 Chapter summary



Test your understanding answers

Test your understanding 1

The correct answer is C $3,000

Cash at bank

	$		$
Sales	1,000	Purchases	380
Loan	5,000	Sundry expenses	20
		Fixtures and fittings	2,600

Test your understanding 2

Cash at bank

	$		$
Sales (1)	60	Insurance (2)	400
		Motor expenses (4)	50
		Purchases (6)	57
		Purchases (7)	40
		Non-current asset (8)	800

Sales

	$		$
		Cash at bank (1)	60
		Receivables (3)	250

Insurance (expense)

	$		$
Cash at bank (2)	400		

Receivables

	$		$
Sales (3)	250		

Motor expenses

	$		$
Cash at bank (4)	50		

Purchases

	$		$
Payables (5)	170		
Cash at bank (6)	57		
Cash at bank (7)	40		

Payables

	$		$
		Purchases (5)	170

Non-current asset (computer)

	$		$
Cash at bank (8)	800		

Test your understanding 3

			$	$
1	Dr	Purchases	5,000	
	Cr	Cash at bank		5,000
2	Dr	Receivables	500	
	Cr	Sales		500
3	Dr	Telephone expense	40	
	Cr	Cash at bank		40
4	Dr	Cash at bank	150	
	Cr	Interest income		150
5	Dr	Stationery expense	12	
	Cr	Cash at bank		12
6	Dr	Cash at bank	400	
	Cr	Sales		400

Test your understanding 4

			$	$
1	Dr	Cash at bank	10,000	
	Cr	Equity/Capital		10,000
2	Dr	Purchases	1,000	
	Cr	Cash at bank		1,000
3	Dr	Cash at bank	400	
	Cr	Sales		400
4	Dr	Receivables	600	
	Cr	Sales		600
5	Dr	Purchases	500	
	Cr	Payables		500
6	Dr	Telephone expense	150	
	Cr	Cash at bank		150
7	Dr	Cash at bank	600	
	Cr	Receivables		600
8	Dr	Payables	340	
	Cr	Cash at bank		340
9	Dr	Cash at bank	30	
	Cr	Interest income		30
10	Dr	Sales returns	20	
	Cr	Cash at bank		20
11	Dr	Payables	100	
	Cr	Purchase returns		100

Test your understanding 5

The correct answer is A $9,360

	$
Output tax on sales:	
Sales tax (230,400 × 20/120)	38,400
Input tax on purchases:	
Sales tax (174,240 × 20/120)	29,040
Payable to tax authorities – net output tax on sales:	
Output tax – Input tax (38,400 – 29,040)	9,360

Test your understanding 6

Sales

	$		$
		Receivables	260,000

Note that sales are recorded excluding sales tax, as this is not income for the business.

Purchases

	$		$
Payables	180,000		

Note that purchases are recorded net of sales tax, as this is not a cost to the business.

Receivables

	$		$
Sales/Sales tax	286,000		

Receivables are recorded including sales tax (the gross amount) as the customer must pay to the business the cost of the goods plus the sales tax.

Payables

	$		$
		Purchases/Sales tax	198,000

As with receivables, the payables must be recorded inclusive of sales tax, as the business needs to pay its suppliers the gross amount.

Sales tax account

	$		$
Payables	18,000	Receivables	26,000
Balance c/f	8,000		
	26,000		26,000
		Balance b/f	8,000

Note: As the balance on the sales tax account represents a liability, it will be classified as a current liability in the statement of financial position.

Test your understanding 7

The correct answer is B – $1,875 Dr

Sales tax

	$		$
Purchases:		Sales	
15,000 × 17.5%	2,625	10,000 × 17.5%	1,750
12,455 × 17.5/117.5	1,855	7,402 × 17.5/117.5	1,102
11,338 × 17.5/117.5	1,689	6,745 × 17.5%	1,180
9,870 × 17.5/117.5	1,470	11,632 × 17.5/117.5	1,732
		Balance c/f	1,875
	7,639		7,639
Balance b/f	1,875		

Test your understanding 8

The correct answer is D

Transaction summary

Date	Customer	Invoice No	Ledger Ref	Gross	Sales tax	Net
				$	$	$
8 July	Simpson	1100	A8	411.25	61.25	350.00
10 July	Burns	1101	B5	1,527.50	227.50	1,300.00
				1,938.75	288.75	1,650.00

The double-entry for the above transactions will be:

Dr	Receivables	$1,938.75
Cr	Sales tax	$288.75
Cr	Sales	$1,650.00

Test your understanding 9

Oli's books:

Dr Cash at bank	$900
Cr Sales	$900

(Net sale = $1,000 – 10%)

Sam's books:

Dr Purchases	$900
Cr Cash at bank	$900

(Net purchase = $1,000 – 10%)

Test your understanding 10

(a) **Payment to Razan**

As payment was made within 10 days, settlement discount of $60 (3% × $2,000) can be deducted from the gross amount, leaving a payment due of $1,940. The accounting entries required to record the payment are as follows:

Debit: Trade payables	$2,000
Credit: Cash at bank	$1,940
Credit: Discount received	$60

The net cost of the goods purchased is $1,940 ($2,000 – $60).

(b) **Receipt from Uli**

As Uli was expected to settle the amount due promptly, the settlement discount of $85 (2.5% × $3,400) was deducted when the invoice was prepared for $3,315. This is the amount of revenue regarded as probably receivable at the date revenue is recorded. The initial transaction would therefore be recorded as follows:

Debit: Trade receivables	$3,315
Credit: Revenue	$3,315

Uli did not make payment within 14 days to be eligible for early settlement discount, and therefore the full amount of $3,400 is due to Georgie. The 'excess receipt' of $85 is therefore accounted for as a cash sale as follows:

Debit: Cash at bank	$3,400
Credit: Trade receivables	$3,315
Credit: Revenue	$85

Chapter

5

Inventory

Chapter learning objectives

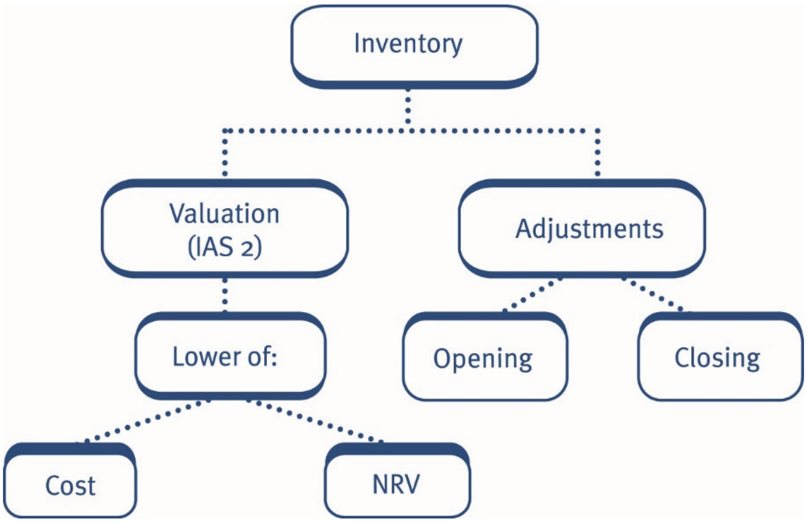
Upon completion of this chapter you will be able to:

- record the adjustments for opening and closing inventory
- apply the principles of inventory valuation in accordance with IAS 2 Inventories
- recognise the costs that should be included in inventory
- calculate inventory cost using the FIFO and AVCO methods
- understand and identify the impact of inventory valuation on reported profits and assets.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter considers how to account for inventory in the financial statements, before moving on to consider how it is valued in accordance with IAS 2 Inventories.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies, in particular for both Financial Reporting and Strategic Business Reporting.

2 Inventory in the financial statements

Many business entities only record inventory in the ledger accounts at the end of the accounting period. During the year, the relevant sales and purchases are recorded but the increase and decrease in inventory assets is ignored. Using this approach, the movement in inventory is considered only on an annual basis. In this way, a business can calculate exactly how much inventory it has used in the year to calculate cost of sales. This is often referred to 'periodic inventory records' and will normally coincide with the annual inventory count and valuation performed at the end of an accounting period.

However, note that some business entities maintain a system of continuous inventory counts throughout the accounting period. They may do this, for example, to enhance control and management of inventory, along with providing a basis for the valuation of inventory at the reporting date for inclusion in the annual financial statements.

The practical application of how a continuous inventory count system is used to determine the inventory valuation is explained and illustrated later within this chapter.

The standard proforma for presenting sales, cost of sales and gross profit is illustrated below:

	$	$
Revenue		X
Opening inventory	X	
Purchases	X	
Less: Closing inventory	(X)	
Cost of sales		(X)
Gross profit		X

Consider a business entity that has some items of inventory left over from the previous year. It then adds to this by purchasing more inventories for the year ahead. It then uses this pool of inventory to manufacture its products, which it will sell to generate sales revenue. At the end of the year there is likely to be some inventory left over to sustain the business in the future.

When calculating gross profit we match the revenue generated from the sales of goods in the year with the costs of manufacturing those goods. You should appreciate that the costs of the unused inventories should not be included in this figure. These costs are carried forward into the next accounting period where they will be used to manufacture goods that are sold in that period.

The goods carried forward are classified as assets on the statement of financial position.

Further explanation of inventory matching

The carrying forward of unused inventory is the application of the matching concept. This is an extension of the accruals concept. Inventory costs are matched to the revenues they help generate.

Illustration 1 – Gross profit calculation

At the beginning of the financial year a business has $1,500 of inventory left over from the preceding accounting period. During the year it purchases additional goods costing $21,000 and make sales totalling $25,000. At the end of the year there are $3,000 of goods left that have not been sold

What is the gross profit for the year?

Solution to Illustration 1

The unsold goods are referred to as closing inventory. This inventory is deducted from purchases in the statement of profit or loss.

Gross profit is thus:

	$	$
Sales revenue		25,000
Opening inventory	1,500	
Purchases	21,000	
Less: Closing inventory	(3,000)	
Cost of sales		(19,500)
Gross profit		5,500

Closing inventory of $3,000 will appear on the statement of financial position as an asset.

Test your understanding 1

Tao buys and sells washing machines and has been trading for many years. On 1 January 20X7, Tao had opening inventory of 30 washing machines which cost $9,500. Tao purchased 65 machines in the year amounting to $150,000 and on 31 December 20X7 there were 25 washing machines left in inventory at a cost of $7,500. Tao has sold 70 machines with a sales value of $215,000 in the year.

Calculate the gross profit for the year ended 31 December 20X7.

3 Year-end inventory adjustments

At the end of the year two basic adjustments are required to recognise opening and closing inventories in the correct place:

1 Inventory brought forward from the previous year is assumed to have been used to generate assets for sale. It must be removed from inventory assets and recognised as an expense in the year

Dr Opening inventory in cost of sales

Cr Inventory assets

2 The unused inventory at the end of the year is removed from purchase costs and carried forward as an asset into the next year:

Dr Inventory assets

Cr Closing inventory in cost of sales

When these entries have been completed, the cost of sales account contains both opening and closing inventory and the inventory ledger account shows the closing inventory for the asset remaining at the end of the year.

Illustration 2 – Recording inventory in the ledger accounts

In TYU 1 Tao had opening inventory of $9,500 at 1 January 20X7. Tao's opening inventory ledger account would be presented as follows:

Inventory

20X7	$		$
1 Jan Balance b/f	9,500		

As inventory is an asset this is currently shown as a debit balance.

At the end of the year the opening inventory must be removed from assets and the expense recognised, as follows:

Dr Cost of sales $9,500

Cr Inventory assets $9,500

To provide a simple illustration of the effect of this adjustment a cost of sales T-account has been set up. This already includes the $150,000 of purchases made by Tao during the year.

Inventory

20X7	$		$
1 Jan bal b/f	9,500	Cost of sales	9,500

Cost of sales

20X7	$		$
Various purchases	150,000		
Inventory	9,500		

Next, the closing inventory for the year of $7,500 must be recognised using the following adjustment:

Dr Inventory assets $7,500

Cr Cost of sales $7,500

Inventory

20X7	$		$
1 Jan bal b/f	9,500	Cost of sales	9,500
31 Dec cost of sales	7,500		

Cost of sales

20X7	$		$
Various purchases	150,000		
1 Jan Inventory	9,500	31 Dec Inventory	7,500

Finally, the ledger accounts can be closed off for the year.

Inventory

20X7	$		$
1 Jan bal b/f	9,500	Cost of sales	9.500
31 Dec cost of sales	7,500	31 Dec bal c/f	7.500
	17,000		17,000
1 Jan X8 bal b/f	7,500		

Cost of sales

20X7	$		$
Various purchases	150,000		
1 Jan Inventory	9,500	31 Dec inventory	7,500
		Taken to profit or loss	152,000
	159,500		159,500

Test your understanding 2

The trading position of Min's cash-based business for its first week of trading was as follows:

	$
Capital introduced by the owner	1,000
Cash purchases	800
Cash sales	900

At the end of the week goods which had cost $300 remained in inventory.

Write up the ledger accounts for the first week and then prepare a vertical statement of profit or loss (i.e. sales revenue, cost of sales and gross profit).

Clearly show the closing inventory asset that would be shown on the statement of financial position at the end of the first week.

You will need to set up two inventory T-accounts: one for inventory assets and one for inventory within cost of sales.

Test your understanding 3	
Min's business described in TYU 2 now continues into its second week. Its transactions were as follows:	
	$
Sales for cash	1,000
Purchases for cash	1,100
The goods left in inventory at the end of this second week originally cost $500.	
Write up the ledger accounts and the vertical statement of profit or loss for week two.	
Clearly identify the closing inventory asset that would appear on the statement of financial position at the end of the second week.	

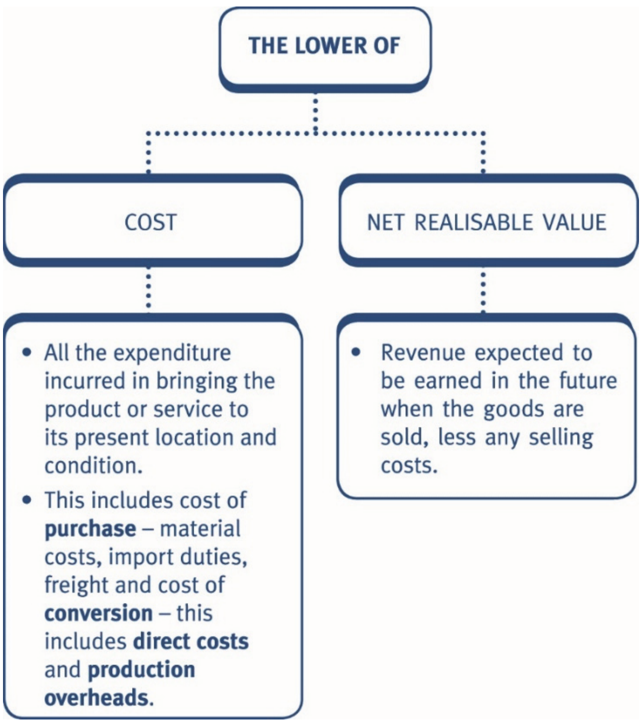
4 Valuation of inventory

Inventory consists of:

- goods purchased for resale
- consumable stores (such as oil)
- raw materials and components (used in the production process)
- partly-finished goods (usually called work in progress – WIP)
- finished goods (which have been manufactured by the business).

IAS 2 Inventories

Inventory is included in the statement of financial position at:



Cost

Cost includes **'all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their current location and condition'** (IAS 2, para 10).

This includes:

- cost of purchase – material costs, import duties, freight.
- cost of conversion – this includes direct costs and production overheads (depreciation of productive machinery/buildings is included here – see later chapter).

According to IAS 2 *Inventories*, the following costs should be excluded from the cost of inventories: selling costs, storage costs, costs of abnormal wastage and administrative overheads. Note, however, that storage costs would be classified as part of the cost of inventory if they were incurred as a necessary part of the production or manufacturing process. An example of this could be a product stored whilst it matures or ripens before it is suitable for the next stage of the production process. Upon reaching an appropriate level of maturity or ripeness, the product would proceed to the next stage of production, or on to finishing or packing and ready for sale.

Net realisable value (also referred to as 'fair value less further costs to sell')

Net realisable value is the net amount that would be realised after incurring any further costs required to make the sale. In effect, it is the fair value of the item, less any further costs that must be incurred in order to sell that item.

This may include, for example, further work and costs required in order to make items of work in progress into finished goods before they could be sold. If IAS 2 is applied, when items of inventory are old or obsolete, they are likely to be valued at net realisable value, rather than cost.

IAS 2 disclosure requirements

According to IAS 1 *Presentation of Financial Statements* entities are required to disclose the accounting policies adopted in preparing their financial statements, including those used to account for inventories. IAS 2 also requires that the total carrying amount of inventories are broken down into appropriate sub-headings or classifications and that the total amount of inventory carried at net realisable value is disclosed.

An example of a specimen disclosure note is as follows:

Inventories are valued at the lower of cost and net realisable value for each separate product or item. Cost is determined by recognising all costs required to get inventory to its location and condition at the reporting date and is applied on a 'first in, first out' basis. Net realisable value is the expected selling price of inventory, less any further costs expected to be incurred to achieve the sale.

	$000
Raw materials	200
Work in progress	600
Finished goods	350
	1,150

Within the carrying amount of inventories, the amount carried at net realisable value is $150,000.

Cost vs Fair value less further costs to sell (NRV)

Example

Gordano Co is a small furniture manufacturing entity. All of its timber is imported from Scandinavia and there are only three basic products – bookcases, dining tables and cupboards. The entity has 200 completed bookcases in inventory at the end of the year. For final accounts purposes, these will be stated at the lower of cost and net realisable value. How is 'cost' arrived at?

Solution

'Cost' will include several elements:

- Cost of purchase. First of all we must identify the timber used in the manufacture of bookcases (as opposed to dining tables and cupboards). The relevant costs will include the cost of the timber, the import duty and all the insurance and freight expenses associated with transporting the timber from Scandinavia to the factory.
- Cost of conversion. This will include costs which can be directly linked to the bookcases produced during the year. This includes labour costs 'booked' and sundry material costs (e.g. hinges and screws). Production overheads present particular problems. Costs such as factory heating and light, salaries of supervisors and depreciation of equipment are likely to relate to the three product ranges. These costs must be allocated to these product ranges on a reasonable basis.

  In particular, any percentage additions to cover overheads must be based on the normal level of production. If this provision was not made, the inventory could be overvalued at the end of a period of low production, because there would be a smaller number of items over which to spread the overhead cost.

These groups of cost must relate to either:

- bookcases sold during the year, or
- bookcases in inventory at the year-end (i.e. 200 bookcases).

Fair value less further costs to sell (NRV)

The comparison between cost and fair value less further costs to sell must be made item by item, not on the total inventory value. It may be acceptable to consider groups of items together if all are worth less than cost.

Test your understanding 4

Cole Co's business sells three products X, Y and Z. The following information was available at the year-end:

	X	Y	Z
	$	$	$
Cost	7	10	19
Fair value less further costs to sell (NRV)	10	8	15
Units	100	200	300

What was the value of the closing inventory?

A $8,400

B $6,800

C $7,100

D $7,200

Test your understanding 5

In what circumstances might the fair value less further costs to sell of inventory be lower than its cost?

Test your understanding 6

Storm Co, an entity, had 500 units of product X at 30 June 20X5. The product had been purchased at a cost of $18 per unit and normally sells for $24 per unit. Recently, product X started to deteriorate but can still be sold for $24 per unit, provided that some rectification work is undertaken at a cost of $3 per unit.

What was the value of closing inventory at 30 June 20X5?

Test your understanding 7

Hurricane Co, an entity, had 1,500 units of product Y at 30 June 20X8. The product had been purchased at a cost of $30 per unit and normally sells for $40 per unit. Recently, product Y started to deteriorate and can now be sold for only $38 per unit, provided that some rectification work is undertaken at a cost of $10 per unit.

What was the value of inventory at 30 June 20X8?

Test your understanding 8

According to IAS 2 *Inventories*, the items that may be included in computing the value of an inventory of finished goods manufactured by a business are clearly specified.

Which one of the following lists consists only of items which may be included in the statement of financial position value of such inventories according to IAS 2?

A Foreman's wages, carriage inwards, carriage outwards, raw materials.

B Raw materials, carriage inwards, costs of storage of finished goods, plant and machinery costs.

C Plant and machinery costs, carriage inwards, raw materials, foreman's wages.

D Carriage outwards, raw materials, foreman's wages, plant and machinery costs.

5 Methods of calculating the cost of inventory

Method	**Key points**	
Unit cost	This is the actual cost of purchasing identifiable units of inventory.	Only used when items of inventory are individually distinguishable and of high value.
FIFO – first in first out	For costing purposes, the first items of inventory received are assumed to be the first ones sold.	The cost of closing inventory is the cost of the most recent purchases of inventory.
AVCO – Average cost	The cost of an item of inventory is calculated by taking the average of all inventory held.	The average cost can be calculated periodically or continuously.

Periodic weighted average cost

With this inventory valuation method, an average cost per unit is calculated based upon the cost of opening inventory plus the cost of all purchases made during the accounting period. This method of inventory valuation is calculated at the end of an accounting period when the total quantity and cost of purchases for the period is known.

Continuous weighted average cost

With this inventory valuation method, an updated average cost per unit is calculated following a purchase of goods. The cost of any subsequent sales are then accounted for at that weighted average cost per unit. This procedure is repeated whenever a further purchase of goods is made during the accounting period.

Note: When using either of the two methods of weighted average cost to determine inventory valuation, it is possible that small rounding differences may arise. They do not affect the validity of the approach used and can normally be ignored.

e.g

Illustration 3

Invicta Co has closing inventory of 5 units at a cost of $4.00 per unit at 31 July 20X5. During the first week of August 20X5, Invicta Co entered into the following transactions:

Purchases

- 2 August – 5 units at $4.50 per unit
- 4 August – 5 units at $5.50 per unit
- 6 August – 5 units at $6.00 per unit

Invicta Co sold 7 units for $11.00 per unit on 5 August.

Required:

(a) **Calculate the value of the closing inventory at the end of the first week of trading in August 20X5 using the following inventory valuation methods:**

1 **FIFO**

2 **periodic weighted average cost**

3 **continuous weighted average cost.**

(b) **Prepare the statement of profit or loss (sales revenue, cost of sales, gross profit) for the first week of trading in August 20X5 using each method of inventory valuation.**

Solution to Illustration 3

(a) 1 **Inventory valuation – FIFO**

With this method of inventory valuation it is assumed that the oldest items of inventory are sold first, thereby leaving the business with the most recently purchased items. This provides an up-to-date valuation method for remaining items of inventory as it uses a recent purchase price to value the majority of goods.

When Invicta Co sold the 7 units on 5 August we assume it sells the oldest items first. Therefore Invicta Co will sell all of the 5 units within opening inventory on 1 August and 2 of the items purchased on 2 August. This leaves Invicta Co with the following items:

3 units × $4.50 =	$13.50
5 units × $5.50 =	$27.50
5 units × $6.00 =	$30.00
Closing inventory cost	**$71.00**

2 **Inventory valuation – periodic AVCO**

With this inventory valuation method, we work out an average cost per unit based upon the cost of opening inventory plus the cost of all purchases made during the accounting period as follows:

Average cost per unit: ((5 × $4.00) + (5 × $4.50) + (5 × $5.50) + (5 × $6.00))/20 units = $5.00 per unit

Closing inventory cost = 13 units × $5.00 = **$65.00**

3 **Inventory valuation – continuous AVCO**

With this inventory valuation method we work out an updated average cost per unit each time a purchase of inventory is made. Any subsequent sales are accounted for at that average cost per unit until the next purchase is made and a new average cost per unit is calculated.

The best way to deal with this is to prepare a schedule dealing with transactions in date order as follows:

Date	Transaction	Units		Cost	Total Cost
				$	$
1 Aug X6	Op inventory	5		4.00	20.00
2 Aug X6	Purchase	5		4.50	22.50
		10	(42.50/10) =	4.25	42.50
4 Aug X6	Purchase	5		5.50	27.50
		15	(70.00/15) =	4.67	70.00
5 Aug X6	**Sale at cost**	**(7)**		**4.67**	**(32.69)**
		8			37.31
6 Aug X6	Purchase	5		6.00	30.00
7 Aug X6	Cl inventory	13	(67.31/13) =	5.18	67.31

(b) **Statements of profit or loss**

Statement of profit or loss using the FIFO method

	$	$
Sales revenue (7 × $11.00)		77.00
Cost of sales		
Opening inventory (5 × $4.00)	20.00	
Purchases (5 × $4.50) + (5 × $5.50) + (5 × $6.00)	80.00	
Less: Closing inventory (see part a)	(71.00)	
		(29.00)
Gross profit		**48.00**

Statement of profit or loss using the periodic AVCO method

	$	$
Sales revenue (7 × $11.00)		77.00
Cost of sales		
Opening inventory (5 × $4.00)	20.00	
Purchases (5 × $4.50) + (5 × $5.50) + (5 × $6.00)	80.00	
Less: Closing inventory (see part a)	(65.00)	
		(35.00)
Gross profit		**42.00**

Statement of profit or loss using the continuous AVCO method

	$	$
Sales revenue (7 × $11.00)		77.00
Cost of sales		
Opening inventory (5 × $4.00)	20.00	
Purchases (5 × $4.50) + (5 × $5.50) + (5 × $6)	80.00	
Less: Closing inventory (see part a)	(67.31)	
		(32.69)
Gross profit		44.31

Test your understanding 9

A business commenced trading on 1 January and purchases were made as follows:

Month	No of units	Unit price	Value
		$	$
Jan	380	2.00	760
Feb	400	2.50	1,000
Mar	350	2.50	875
Apr	420	2.75	1,155
May	430	3.00	1,290
Jun	440	3.25	1,430
	2,420		6,510

In June, 1,420 articles were sold for $7,000.

What is the cost of closing inventory and gross profit for the period using the FIFO method?

	Closing inventory	**Gross profit**
	$	$
A	2,690	3,180
B	2,310	2,800
C	3,077	3,567

Test your understanding 10

On 1 July 20X6 an entity, Pinto Co, had 10 items of inventory at a unit cost of $8.50. Pinto Co, then made the following purchases and sales during a six month period to 31 December 20X6:

Purchases:

Date	**Quantity**	**Unit cost**	**Total cost**
		$	$
14 Oct X6	15	9.00	135.00
22 Nov X6	25	9.20	230.00
13 Dec X6	20	9.50	190.00
	60		555.00

Sales:

Date	**Quantity**	**Unit Selling price**	**Total cost**
		$	$
23 Aug X6	7	12.00	84.00
20 Oct X6	10	12.25	122.50
30 Nov X6	15	12.50	187.50
24 Dec X6	18	13.00	234.00
	50		628.00

Required:

Based upon the available information, calculate the closing inventory valuation at 31 December 20X6 using:

(a) **periodic weighted average cost**

(b) **continuous weighted average cost.**

Profit and statement of financial position

The impact of valuation methods on profit and the statement of financial position.

Different valuation methods will result in different closing inventory values. This impacts both profit and statement of financial position asset value. For this reason it is important that once a method has been selected it is applied consistently. It is not appropriate to keep switching between methods to manipulate reported profits.

Similarly any incorrect valuation of inventory will impact the financial statements.

If inventory is overvalued then:

- assets are overstated in the statement of financial position
- profit is overstated in the statement of profit or loss (as cost of sales is too low),

If inventory is undervalued then:

- assets are understated in the statement of financial position
- profit is understated in the statement of profit or loss (as cost of sales is too high).

Period-end vs continuous inventory records

Keeping inventory records

When preparing the financial statements, quantifying closing inventory can be a major exercise for a business. Traditionally inventory is counted and compared to inventory records at the year-end. This is referred to as the 'period-end' or 'periodic' method of inventory counting.

Alternatively a business could count a sample of inventory items at each week or month end and compare the results of those counts with the inventory records at that time. Throughout the accounting period the idea would be to count all lines of inventory at least once. This is referred to as 'continuous' inventory counting.

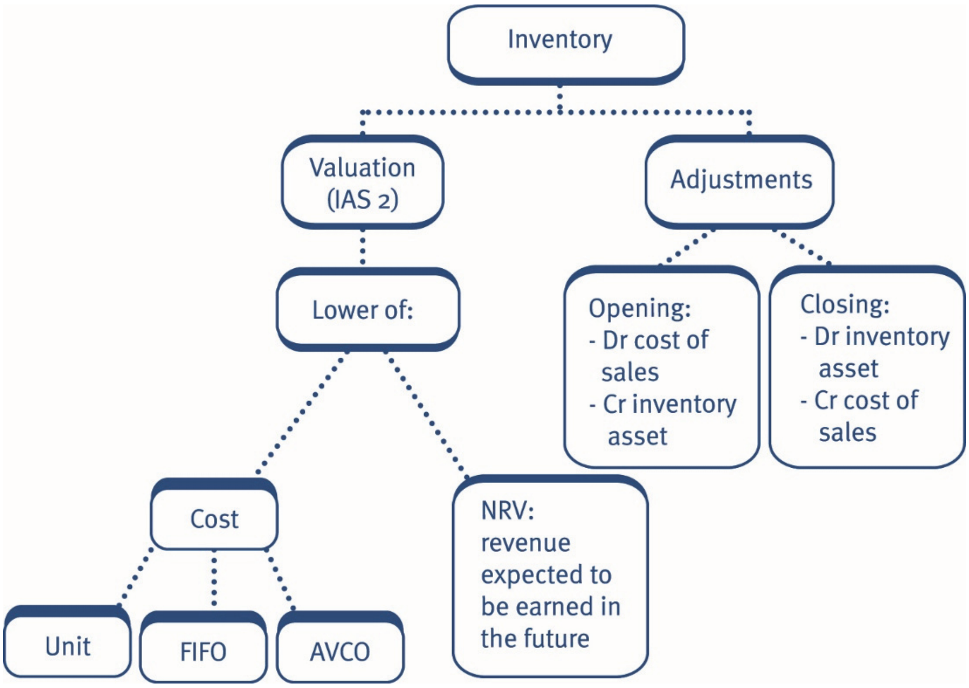
The merits of continuous inventory records are as follows:

- There is better information for inventory control.
- Excessive build-up of certain lines of inventory whilst having insufficient inventory of other lines is avoided.
- Less work is needed to calculate inventory at the end of the accounting period.

The merits of period-end inventory records are as follows:

- They are cheaper in most situations than the costs of maintaining continuous inventory records.
- Even if there is a continuous inventory record, there will still be a need to check the accuracy of the information recorded by having a physical check of some of the inventory lines.

6 Chapter summary



Test your understanding answers

Test your understanding 1

- Gross profit is sales revenue less cost of sales.
- We must match the 70 machines sold with the cost of those machines and exclude from cost of sales the machines that are left in inventory.
- Opening inventory must be included in cost of sales as some of the goods sold during the year come from the goods the trader started off with at the beginning of the year.
- We can calculate the gross profit as follows:

	$	$
Sales revenue		215,000
Opening inventory	9,500	
Purchases	150,000	
	159,500	
Less: Closing inventory	(7,500)	
Cost of sales		(152,000)
Gross profit		63,000

Test your understanding 2

First, the transactions are entered into the general ledger accounts, and the accounts are balanced. Revenue and purchases are then transferred to the statement of profit or loss.

Capital

	$		$
Bal c/f	1,000	Bank	1,000
	1,000		1,000
		Bal b/f	1,000

Bank

	$		$
Capital	1,000	Purchases	800
Sales revenue	900	Balance c/f	1,100
	1,900		1,900
Balance b/f	1,100		

Sales revenue

	$		$
Taken to profit or loss	900	Bank	900

Purchases

	$		$
Bank	800	Taken to profit or loss	800

Next, the closing inventory must be accounted for in the inventory asset account and the profit or loss account, specifically as part of the cost of sales calculation. There is no opening inventory as this is the first week of trading for the business.

Inventory asset

	$		$
Cost of sales	300	Bal c/f	300
	300		300
Bal b/f	300		

Cost of sales

	$		$
Taken to profit or loss	300	Closing inventory	300
	300		300

Statement of profit or loss for Week 1

	$	$
Sales revenue		900
Cost of sales:		
Purchases	800	
Less: Closing inventory	(300)	
		(500)
Gross profit		400

The closing inventory asset in the statement of financial position is $300.

Test your understanding 3

First, the ledger accounts must be written up. You must remember that there are opening balances on the statement of financial position accounts (Bank and capital) but the profit or loss accounts have no opening balances as they were transferred to the statement of profit or loss in Week 1.

Capital

	$		$
Bal c/f	1,000	Bal b/f	1,000
	1,000		1,000
		Bal b/f	1,000

Bank

	$		$
Balance b/f	1,100	Purchases	1,100
Sales revenue	1,000	Balance c/f	1,000
	2,100		2,100
Balance b/f	1,000		

Sales revenue

	$		$
Taken to profit or loss	1,000	Bank	1,000

Purchases

	$		$
Bank	1,100	Taken to profit or loss	1,100

The opening inventory must be transferred to the statement of profit or loss, and the closing inventory entered into the ledger accounts (inventory and profit or loss) leaving the balance carried forward which will be included in the statement of financial position.

Inventory

	$		$
Balance b/f	300	Cost of sales	300
Cost of sales	500	Bal c/f	500
	800		800
Bal b/f	500		

Cost of sales

	$		$
Opening inventory	300	Closing inventory	500
Taken to profit or loss	200		
	500		500

Statement of profit or loss for Week 2

	$	$
Sales revenue		1,000
Cost of sales:		
Opening inventory	300	
Purchases	1,100	
	1,400	
Less: Closing inventory	(500)	
		(900)
Gross profit		100

The inventory asset on the statement of financial position at the end of week two is $500.

Test your understanding 4

The correct answer is B

X	$7	(cost) × 100 =	$700
Y	$8	(NRV) × 200 =	$1,600
Z	$15	(NRV) × 300 =	$4,500
Total			$6,800

Test your understanding 5

Fair value less further costs to sell may be relevant in special cases, such as where goods are slow-moving, damaged or obsolete. However, items of inventory will normally be stated at cost if they can be sold at a price greater than their cost of purchase.

Test your understanding 6

$9,000

IAS 2 requires that inventory is valued at the lower of either cost ($18 per unit) or fair value less further costs to sell ($24 – $3 = $21 per unit). Inventory is therefore valued at $18 per unit, giving a valuation for 500 units of $9,000.

Test your understanding 7

$42,000

IAS 2 requires that inventory is valued at the lower of either cost ($30 per unit) or fair value less further costs to sell ($38 – $10 = $28 per unit). Inventory is therefore valued at fair value less further costs to sell of $28 per unit, giving a valuation for 1,500 units of $42,000.

Test your understanding 8

The correct answer is C

The other three answers contain items which cannot be included in the cost of inventory according to IAS 2.

Test your understanding 9

The correct answer is C

- Inventory valuation (inventory in hand 2,420 – 1,420 = 1,000 units)
- FIFO – inventory valued at latest purchase prices

		$
440	articles at $3.25	1,430
430	articles at $3.00	1,290
130	articles at $2.75	357
1,000		3,077

Calculation of gross profit:

	$	$
Sales revenue		7,000
Purchases	6,510	
Less: closing inventory	(3,077)	
Cost of sales		(3,433)
Gross profit		3,567

Test your understanding 10

(a) **Periodic weighted average cost per unit**

Date	**Quantity**	**Unit cost**	**Total cost**
		$	$
1 Jul X6 – op inventory	10	8.50	85.00
14 Oct X6	15	9.00	135.00
22 Nov X6	25	9.20	230.00
13 Dec X6	20	9.50	190.00
	70		640.00

Therefore, periodic weighted average cost per unit = $640.00/70 units = $9.14

Closing inventory = 70 units – 50 sold = 20 units × $9.14 = $182.80

(b) **Continuous weighted average cost per unit**

Date	**Quan -tity**		**Unit cost**	**Total cost**
			$	$
1 Jul X6 – op inventory	10		8.50	85.00
23 Aug X6 – sales	(7)		8.50	(59.50)
	3			25.50
14 Oct X6 – purchases	15		9.00	135.00
	18	(160.50/ 18) =	8.92	160.50
20 Oct X6 – sales	(10)		8.92	(89.20)
	8			71.30
22 Nov X6 – purchases	25		9.20	230.00
	33	(301.30/ 33) =	9.13	301.30
30 Nov X6 – sales	(15)		9.13	(136.95)
	18			164.35
13 Dec X6 – purchases	20		9.50	190.00
	38	(354.35/ 38) =	9.32	354.35
24 Dec X6 – sales	(18)		9.32	(167.76)
Closing inventory	**20**		**9.32**	**186.40**
		Rounding – ignore		0.19

Chapter

6

Non-current assets: acquisition and depreciation

Chapter learning objectives

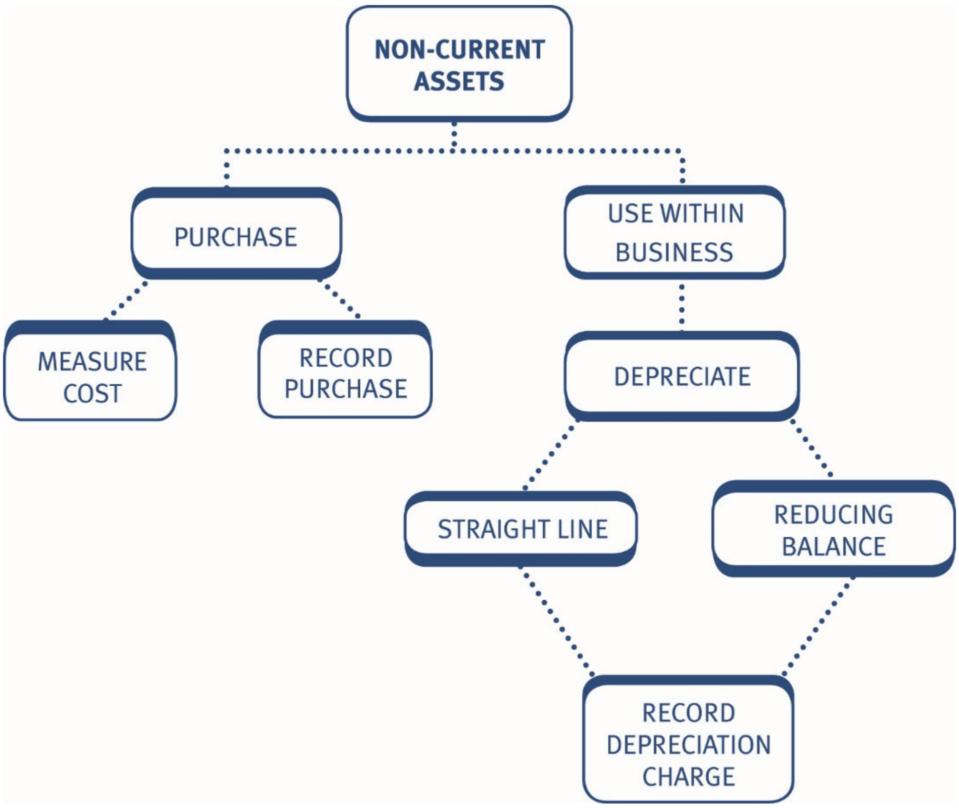
Upon completion of this chapter you will be able to:

- define non-current assets
- explain the difference between asset expenditure and expenses
- explain the purpose of an asset register
- prepare ledger entries to record the acquisition of non-current assets
- define, calculate and record the depreciation charge on non-current assets.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter defines what a non-current asset is, before considering how non-current assets are measured and classified for inclusion in the financial statements. Importantly, this chapter also considers the accounting requirements of IAS 16 *Property, Plant and Equipment*.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies, in particular for Financial Reporting and Strategic Business Reporting.

2 Non-current assets

Non-current assets are distinguished from current assets because they:

- are long-term in nature
- are not normally acquired for resale
- could be tangible or intangible
- are used to generate income directly or indirectly for a business
- are not normally liquid assets (i.e. not easily and quickly converted into cash without a significant loss in value).

3 Asset expenditure and expenses

It follows that a business' expenditure may be classified as one of two types:

ASSET EXPENDITURE

- Expenditure on the acquisition of non-current assets required for use in the business, not for resale.
- Expenditure on existing non-current assets aimed at increasing their earning capacity.

Asset expenditure is long-term in nature as the business intends to receive the benefits of the expenditure over a long period of time.

EXPENSE

- Expenditure on current assets.
- Expenditure relating to running the business (such as administration costs).
- Expenditure on maintaining the earning capacity of non-current assets e.g. repairs and renewals.

Expense expenditure relates to the current accounting period and is used to generate revenue in the business.

4 Non-current asset registers

Non-current asset registers are, as the name suggests, a record of the non-current assets held by an entity. The registers form part of the internal control system of an entity.

Non-current asset register

Details held on such a register may include:

- cost
- date of purchase
- description of asset
- serial/reference number
- location of asset
- depreciation method
- expected useful life
- carrying amount (net book value).

5 Acquisition of a non-current asset

A non-current asset register is maintained in order to control non-current assets and keep track of what is owned and where it is kept.

It is periodically reconciled to the non-current asset accounts maintained in the general ledger.

- The cost of a non-current asset is any amount incurred to acquire the asset and bring it into working condition

According to IAS 16 *Property Plant and Equipment*, cost consists of, or excludes, the following elements:

Includes	**Excludes**
Asset expenditure such as • purchase price • delivery costs • legal fees • subsequent expenditure which enhances the asset • trials and tests	Expenses such as: • repairs • renewals • repainting • administration • general overheads • training costs • wastage

- The correct double-entry to record the purchase is:

  Dr Non-current asset X

  Cr Bank/Payables X

- A separate cost account should be kept for each category of noncurrent asset, e.g. motor vehicles, fixtures and fittings.

Subsequent expenditure

Subsequent costs on the non-current asset can only be recorded as part of the cost (or capitalised), if it enhances the benefits of the asset, i.e. increases the revenues capable of being generated by the asset.

An example of subsequent expenditure which meets this criterion, and so can be capitalised, is an extension to a shop building which provides extra selling space.

An example of subsequent expenditure which does not meet this criterion is repair work. Any repair costs must be debited to the statement of profit or loss, i.e. expensed.

Test your understanding 1

Billie started a business providing limousine taxi services on 1 January 20X5. In the year to 31 December Billie incurred the following costs:

	$
Office premises	250,000
Legal fees associated with purchase of office	10,000
Cost of materials and labour to paint office in Bilbo's favourite colour, purple	300
Mercedes E series estate cars	116,000
Number plates for cars	210
Delivery charge for cars	180
Road licence fee for cars	480
Drivers' wages for first year of operation	60,000
Blank taxi receipts printed with Bilbo Baggins' business name and number	450

What amounts should be capitalised as 'Land and buildings' and 'Motor vehicles'?

	Land and buildings	Motor vehicles
A	260,000	116,390
B	250,000	116,870
C	250,300	116,390
D	260,300	116,870

6 Depreciation

- IAS 16 *Property Plant and Equipment* defines depreciation as **'the systematic allocation of the depreciable amount of an asset over its useful life'** (IAS 16 para 6).
- In simple terms, depreciation spreads the cost of the asset over the period in which it will be used.
- Depreciation matches the cost of using a non-current asset to the revenues generated by that asset over its useful life.
- Depreciation must also be matched to the pattern of use of the asset. According to IAS 16, the estimated useful life of items of property, plant and equipment must be regularly reviewed and may be changed if the method no longer matches the usage of the asset.

- This is achieved by recording a depreciation charge each year, the effect of which is twofold ('the dual effect'):
  - reduce the statement of financial position value of the non-current asset by accumulated depreciation to reflect the wearing out, and
  - record the depreciation charge as an expense in the statement of profit or loss to match to the revenue generated by the non-current asset.

Further discussion of depreciation

Depreciation may arise from:

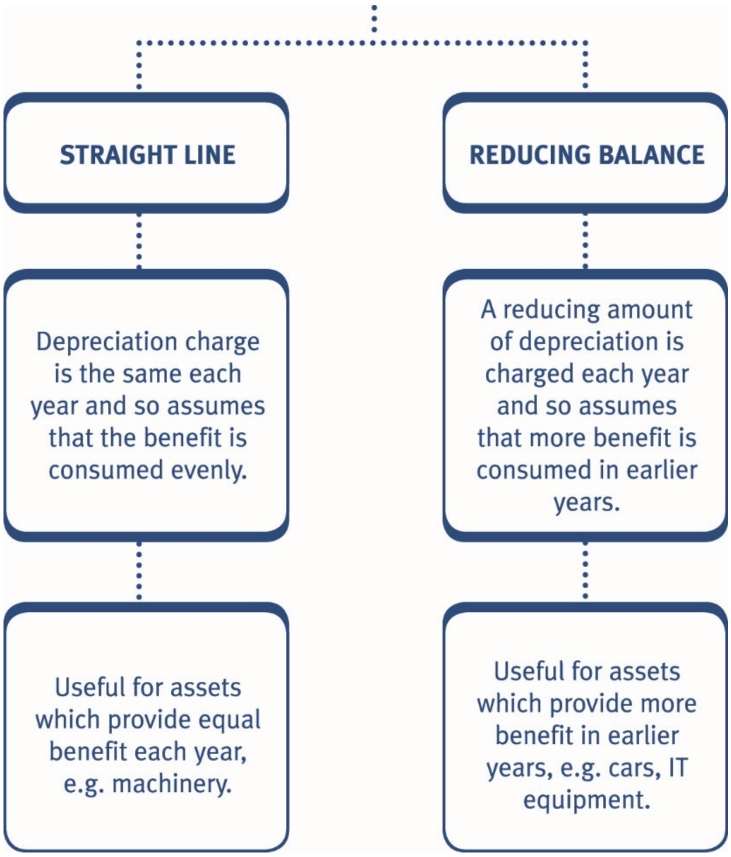
- use
- physical wear and tear
- passing of time, e.g. a ten-year lease on a property
- obsolescence through technology and market changes, e.g. plant and machinery of a specialised nature
- depletion, e.g. the extraction of a mineral from a quarry.

The purpose of depreciation is not to show the asset at its current value in the statement of financial position, nor is it intended to provide a fund for the replacement of the asset. It is simply a method of allocating the cost of the asset over the periods estimated to benefit from its use (the useful life).

According to IAS 16 land normally has an unlimited life and so **does not require depreciation**, but buildings should be depreciated.

Depreciation of an asset begins when it is available for use.

7 Methods of calculating depreciation



IAS 16 says that **'the depreciation method applied to an asset should reflect the pattern in which the assets future economic benefits are expected to be consumed'** (IAS 16 para 60).

Straight-line method

Depreciation charge = (Cost – Residual value)/Useful life

Alternatively it can simply be given as a simple percentage of cost.

Residual value: the estimated disposal value of the asset at the end of its useful life.

Useful life: the estimated number of years during which the business will use the asset.

The straight line method results in the same charge every year and is used wherever the pattern of usage of an asset is consistent throughout its life. Buildings are commonly depreciated using this method because businesses will commonly get the same usage out of a building every year.

Useful life

The useful life does not necessarily equal the physical life of the asset. For example many businesses use a three-year useful life for computers. This does not mean that a computer can no longer be used after three years; it means that the business is likely to replace the computer after three years due to technological advancement.

Reducing balance method

Depreciation charge = X % × carrying amount

CA: original cost of the non-current asset less accumulated depreciation on the asset to date.

The reducing balance method results in a constantly reducing depreciation charge throughout the life of the asset. This is used to reflect the expectation that the asset will be used less and less as it ages. This is a common method of depreciation for vehicles, where it is expected that they will provide less service to the business as they age because of the increased need to service/repair them as their mileage increases.

Assets bought/sold in the period

If a non-current asset is bought or sold in the period, there are two ways in which the depreciation could be accounted for:

- provide a full year's depreciation in the year of acquisition and none in the year of disposal
- monthly or pro-rata depreciation, based on the exact number of months that the asset has been owned.

Illustration 1 – Reducing balance method

Wei, a trader, purchased an item of plant for $1,000 on 1 August 20X1 which depreciates on the reducing balance at 20% pa.

What is the depreciation charge for each of the first five years if the accounting year end is 31 July?

Solution to Illustration 1

Year	Depreciation charge % × CA	Depreciation charge	Accumulated depreciation
		$	$
1	20% × $1,000	200	200
2	20% × $(1,000 – 200)	160	360
3	20% × $(1,000 – 360)	128	488
4	20% × $(1,000 – 488)	102	590
5	20% × $(1,000 – 590)	82	672

Test your understanding 2

Kai has been running a successful nursery school 'Little Imps' since 20X1. Kai bought the following assets as the nursery expanded:

- a new oven for the nursery kitchen at a cost of $2,000 (purchased 1 December 20X4).
- a minibus to take the children on trips for $18,000 (purchased 1 June 20X4).

Kai depreciates the oven at 10% straight line and the minibus at 25% reducing balance. A full year's depreciation is charged in the year of purchase and none in the year of disposal.

What is the total depreciation charge for the year ended 31 October 20X6?

A $2,531

B $2.700

C $4,231

D $2,731

Test your understanding 3

The following information relates to Bangers & Smash, a car repair business:

	Machine 1	**Machine 2**
Cost	$12,000	$8,000
Purchase date	1 August 20X5	1 October 20X6
Depreciation method	20% straight line pro rata	10% reducing balance pro rata

What is the total depreciation charge for the years ended 31 December 20X5 and 20X6?

	20X5	**20X6**
	$	$
A	2,400	2,600
B	1,000	2,600
C	2,400	3,200
D	1,000	3,200

8 Accounting for depreciation

Whichever method is used to calculate depreciation, the accounting remains the same:

Dr Depreciation expense (P/L) X

Cr Accumulated depreciation (SFP) X

- The depreciation expense account is a profit or loss account and therefore is not accumulated.
- The accumulated depreciation account is a statement of financial position account and as the name suggests is accumulated, i.e. reflects all depreciation to date.
- On the statement of financial position it is shown as a reduction against the cost of non-current assets:

	$
Cost	X
Accumulated depreciation	(X)
Carrying amount	X

Illustration 2 – Accounting for depreciation

Sam runs a large toy shop in Windsor. During the year ended 31 August 20X5, Sam purchased the following non-current assets:

- A new cash register for $5,000. This was purchased on 1 December 20X4, in time for the Christmas rush, and was to be depreciated at 10% straight line.
- A new delivery van, purchased on 31 March 20X5, at a cost of $22,000. The van is to be depreciated at 15% reducing balance.

Sam charges depreciation on a monthly basis.

- **What is the depreciation charge for the year ended 31st August 20X5?**
- **Show the relevant ledger accounts and statement of financial position presentation at that date.**

Solution to Illustration 2

Cash register Depreciation charge: 10% × $5,000 × 9/12 = $375

Delivery van Depreciation charge: 15% × $22,000 × 5/12 = $1,375

Asset cost (cash register)

	$		$
Cost	5,000	Balance c/f	5,000
	5,000		5,000
Balance b/f	5,000		

Asset cost (delivery van)

	$		$
Cost	22,000	Balance c/f	22,000
	22,000		22,000
Balance b/f	22,000		

Accumulated depreciation (cash register)

	$		$
Balance c/f	375	Depreciation expense 20X5	375
	375		375
		Balance b/f	375

Accumulated depreciation (delivery van)

	$		$
Balance c/f	1,375	Depreciation expense 20X5	1,375
	1,375		1,375
		Balance b/f	1,375

Depreciation expense

	$		$
Accumulated dep'n (cash register)	375		
Accumulated dep'n (delivery van)	1,375	Profit or loss	1,750
	1,750		1,750

Statement of financial position extract at 31 August 20X5

Non-current assets	**Cost**	**Accumulated depreciation**	**CA**
	$	$	$
Cash register	5,000	(375)	4,625
Delivery van	22,000	(1,375)	20,625
Total	27,000	(1,750)	25,250

Test your understanding 4

Chris acquired two non-current assets on 1 August 20X5 for use in a recently started hospitality business:

- a property with a 25-year useful life for $200,000 with no expected residual value
- a chocolate fountain for $4,000.

The fountain is to be depreciated at 25% pa using the reducing balance method.

A full year of depreciation is charged in the year of acquisition and none in the year of disposal.

Show the ledger account entries for these assets for the years ending 31 October 20X5, 20X6 and 20X7.

9 Changing estimates

Businesses should apply the same rates and methods of depreciation consistently throughout the life of their business. However, if a business believes that its estimates of useful life and/or residual value are inappropriate it is permitted to change them with no further recourse. In order to do this you simply work out the new depreciation charge of the asset based on the revised estimate of useful life or residual value.

Illustration 3 – Changes to estimates

Alfie purchased a non-current asset for $100,000 on 1 January 20X2 and started depreciating it over five years. Residual value was taken as $10,000.

At 1 January 20X3 a review of asset lives was undertaken and the remaining useful life of the asset was estimated at eight years. Residual value was estimated to be nil.

Calculate the depreciation charge for the year ended 31 December 20X3 and subsequent years.

Solution to Illustration 3

Initial depreciation charge

= ($100,000 – $10,000)/5 years = $18,000 pa.

At 1 Jan 20X3 the asset would have accumulated one year' of depreciation. Its carrying amount would therefore be $100,000 – $18,000 = $82,000.

At this point the asset is estimated to have a remaining useful life of 8 years and $nil residual value. From now on the depreciation charge will be $82,000/8 years = **$10,250 pa.**

Test your understanding 5

Yan bought a wood-burning oven for $30,000 on 1 January 20X0 to use in a new restaurant. At that time Yan believed that the oven's useful life would be 20 years after which it would have no value.

On 1 January 20X3, Yan revised the estimations previously made: the estimated life of the oven to the business was reassessed to a further 12 years after which it could be sold for $1,500.

What is the depreciation charge for the year ended 31 December 20X3?

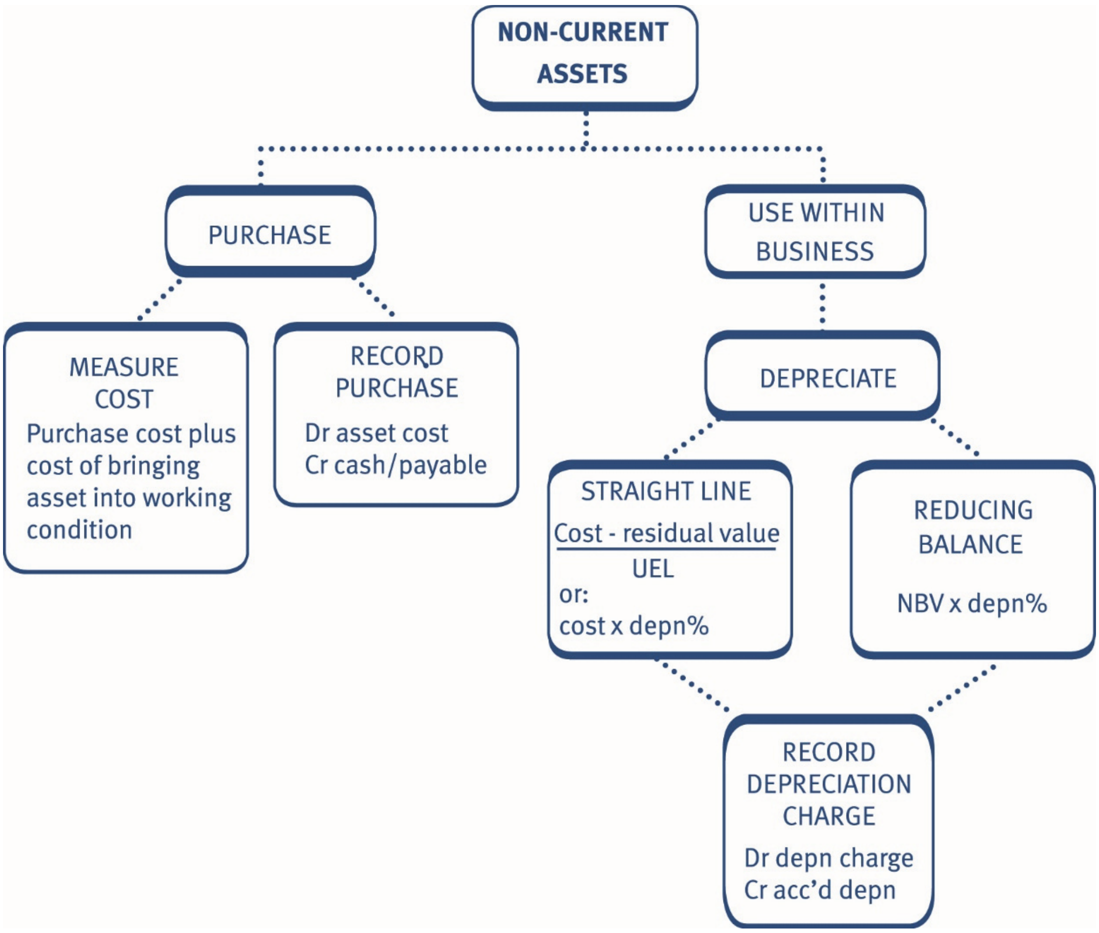
A $2,000

B $2,125

C $1,875

D $2,375

10 Chapter summary



Test your understanding answers

Test your understanding 1

The correct answer is A

Land and buildings

Office premises: $250,000

Legal fees: $10,000

Total: $260,000

- The cost of the purple paint does not form part of the cost of the office and so should not be capitalised. Instead it should be taken to the statement of profit or loss as an expense.

Motor vehicles

3 Mercedes E series: $116,000

Number plates: $210

Delivery charges: $180

Total: $116,390

- The number plates are one-off charges which form part of the purchase price of any car.
- The road licence fee, drivers' wages and receipts are ongoing expenses, incurred every year. They cannot be capitalised, but should be taken to the statement of profit or loss as expenses.

Test your understanding 2

The correct answer is D

Oven	**20X6**
	$
£2,000 × 10%	200
Minibus	
20X4: 25% × $18,000 = $4,500	
20X5: 25% × $(18,000 – 4,500) = $3,375	
20X6: 25% × $(18,000 – 7,875) = $2,531	2,531
Total depreciation charge	2,731

Test your understanding 3

The correct answer is B

Machine 1

20X5: 20% × $12,000 × 5/12 = $1,000

20X6: 20% × $12,000 = $2,400

Machine 2

20X6: 10% × $8,000 × 3/12 = $200

Total depreciation charge

20X5: $1,000

20X6: $2,400 + $200 = $2,600

Test your understanding 4

Property (cost)

	$		$
1.8.X5 Bank	200,000	Balance c/f	200,000
	200,000		200,000
Balance b/f	200,000		

Fountain (cost)

	$		$
1.8.X5 Bank	4,000	Balance c/f	4,000
	4,000		4,000
Balance b/f	4,000		

Depreciation charge – Property & Fountain

	$		$
X5 accumulated depreciation	9,000	Profit or loss	9,000
X6 accumulated depreciation	8,750	Profit or loss	8,750
X7 accumulated depreciation	8,563	Profit or loss	8,563

Accumulated depreciation – Property

	$		$
		X5 depreciation charge	8,000
Balance c/f	8,000		
	8,000		8,000
		Balance b/f	8,000
		X6 depreciation charge	8,000
Balance c/f	16,000		
	16,000		16,000
		Balance b/f	16,000
		X7 depreciation charge	8,000
Balance c/f	24,000		
	24,000		24,000
		Balance b/f	24,000

Accumulated depreciation – Fountain

	$		$
		X5 depreciation charge	1,000
Balance c/f	1,000		
	1,000		1,000
		Balance b/f	1,000
		X6 depreciation charge	750
Balance c/f	1,750		
	1,750		1,750
		Balance b/f	1,750
		X7 depreciation charge	563
Balance c/f	2,313		
	2,313		2,313
		Balance b/f	2,313

Annual depreciation workings:

Note, details of the depreciation method and rate for the property are not given in the question. We are however told that the property has an expected useful life of 25 years with no expected residual value. This suggests that it would be appropriate to use the straight-line method with a useful life of 25 years.

20X5

Property: $200,000/25 years = $8,000

Fountain: $4,000 × 25% = $1,000

Total: 9,000

20X6

Property: $200,000/25 years = $8,000

Fountain: $3,000 × 25% = $750

Total: 8,750

20X7

Property: $200,000/25 years = $8,000

Fountain: $2,250 × 25% = $563

Total: $8,563

Test your understanding 5

The correct answer is A

Initial depreciation charge = $30,000/20 years = $1,500

CA at date of change = $30,000 – ($1,500 × 3 years) = $25,500

New depreciation charge = $25,500 – $1,500/12 years = $2,000 pa

Chapter

7

Non-current assets: disposal and revaluation

Chapter learning objectives

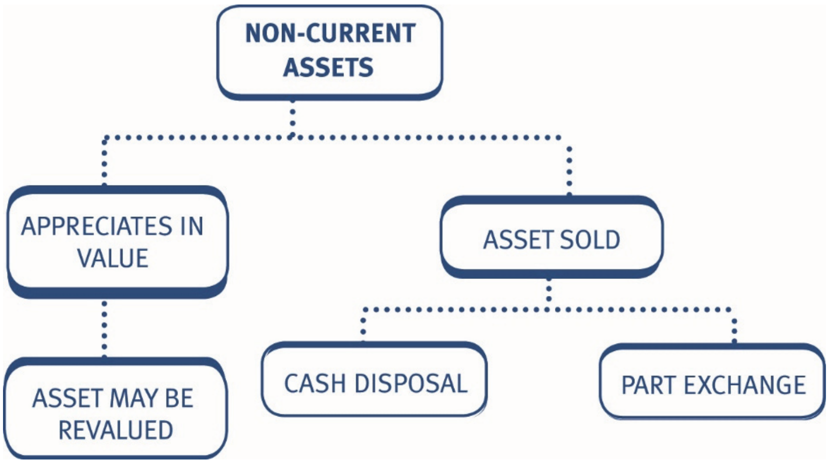
Upon completion of this chapter you will be able to:

- prepare ledger entries to record the disposal of non-current assets, including part exchange transactions
- calculate profits or losses on disposal
- record the revaluation of a non-current asset
- calculate the profit or loss on the disposal of a revalued asset
- illustrate how non-current assets are disclosed in the financial statements.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter develops the principles considered in the previous chapter and deals with accounting for the disposal and revaluation of property, plant and equipment.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies, in particular for Financial Reporting and Strategic Business Reporting.

2 Disposal of non-current assets

IAS 16 says that **'the carrying amount of an item of property, plant and equipment shall be derecognised on disposal or when no future economic benefits are expected from its use or disposal'** (IAS 16 para 67). When a tangible non-current asset is disposed of ('derecognised') there are a number of adjustments required to remove the asset and associated accumulated depreciation from the statement of financial position and to record a profit or loss on the disposal.

Profit/loss on disposal

Proceeds > CA at disposal date	= Profit
Proceeds < CA at disposal date	= Loss
Proceeds = CA at disposal date	= Neither profit nor loss

Note: A disposals T-account is required when recording the disposal of a non-current asset. This is a profit or loss account.

Disposal for cash consideration

This is a three-step process:

1 Remove the **original cost** of the non-current asset from the 'non-current asset' account.

Dr Disposals account

Cr NC asset cost account

2 Remove **accumulated depreciation** on the non-current asset from the 'accumulated depreciation' account.

Dr Accumulated depreciation account

Cr Disposals account

3 Record the **proceeds**.

Dr Bank account

Cr Disposals account

The balance on the disposals T-account is the profit or loss on disposal:

Disposal

Original cost	X	Accumulated depreciation	X
		Bank – cash proceeds	X
Profit on disposal	ß	Loss on disposal	ß
	—		—
	X		X
	—		—

The profit or loss on disposal can also be calculated as proceeds less CA of asset at disposal.

Test your understanding 1

Pat runs a landscape gardening business. On 1 February 20X2, Pat purchased a sit-on lawnmower costing $3,000, which is depreciated at 10% per annum straight line on a monthly basis. Pat decided to replace it with one which has an enclosed cabin for use when it rains. The lawnmower was sold to an old friend for $2,000 on 31 July 20X5.

How much is total charged to Pat's statement of profit or loss relating to the asset sold for the year ended 31 December 20X5?

Disposal through a part-exchange agreement (PEA)

A part-exchange agreement arises where an old asset is provided in part payment for a new one, the balance of the new asset being paid in cash.

The procedure to record the transaction is very similar to the three-step process seen for a cash disposal.

The first two steps are identical; however steps 3 and 4 are as follows:

3 Record the **part-exchange allowance** (PEA) as proceeds.

Dr NC assets cost account (= part of cost of new asset)

Cr Disposals account (= sale proceeds of old asset)

4 Record the **cash paid** for the new asset.

Dr NC asset cost account

Cr Bank account

Again, the balance on the disposals T-account is the profit or loss on disposal:

Disposal

Original cost	X	Accumulated depreciation	X
		Bank – cash proceeds	X
Profit on disposal	ß	Loss on disposal	ß
	—		—
	X		X
	—		—

Test your understanding 2

Sanyu runs a business altering and repairing clothes. When Sanyu started business on 1 January 20X2, a Soopastitch II sewing machine was purchased at a cost of $2,500. Sewing machines are depreciated using the straight-line method at a rate of 20% pa, and a full year of depreciation is charged in the year of acquisition and none in the year of disposal.

The business has now grown such that Sanyu needs a faster machine, and will upgrade to the Soopastitch V during December 20X5. The Soopastitch salesperson has offered a part-exchange deal as follows:

Part exchange allowance for Soopastitch II $750

Balance to be paid in cash for Soopastitch V $4,850

Show the ledger entries for the year ended 31 December 20X5 to reflect this transaction.

3 Revaluation of non-current assets

So far, the focus has been upon accounting for the cost of an item of property, plant and equipment, and the associated requirement to account for depreciation.

According to IAS 16, items of property, plant and equipment can be measured and accounted for using the revaluation model. Some non-current assets, such as land and buildings may rise in value over time. A company (rather than sole traders and partnerships) may choose to reflect the value of the asset in its statement of financial position. This is known as revaluing the asset.

IAS 16 says that **'If an asset's carrying amount is increased as a result of a revaluation, the increase shall be recognised in other comprehensive income and accumulated in equity under the heading of revaluation surplus'** (IAS 16, para 39). This will be covered later in the text.

This gain is not recorded in the statement of profit or loss because it is unrealised. Think about owning a house; the value of the house may appreciate in value over time. You can't go out and spend that increase in value on a new car though because it is not a real gain to you; it only becomes real when you sell the house and receive the benefit from that sale. Until that point it is a hypothetical gain (i.e. how much you would gain if you sold it at that point in time). Don't forget, the house could fall in value again by the time you sell it leaving you to find other ways to fund that car you just agreed to buy!

As this increase in value represents an unrealised gain we cannot record it as part of the profit earned during the year. IAS 1 requires that revaluation gains are disclosed separately from profit in 'other comprehensive income'. (This is covered in a later chapter.)

e.g

Illustration 1 – Revaluation of non-current assets

Vanguard owns land which originally cost $250,000. No depreciation has been charged on the land in accordance with IAS 16. Vanguard wishes to revalue the land to reflect its current market value, which it has been advised is $350,000.

How is this reflected in the financial statements?

Solution to Illustration 1

The land is currently held at cost of $250,000. This needs to be increased by $100,000 to reflect the new valuation of $350,000. Therefore the following is required:

Statement of profit or loss and other comprehensive income:

Other comprehensive income – item that will not be reclassified in subsequent accounting periods:

Revaluation surplus in the year $100,000

Statement of financial position:

Dr Non-current asset – land $100,000

Cr Revaluation surplus (within equity) $100,000

Illustration 2 – Revaluation of non-current assets

Hamstrung runs a kilt-making business in Scotland. It has run the business for many years from a building which originally cost $300,000 and on which $100,000 accumulated depreciation has been charged to date. Hamstrung wishes to revalue the building to $750,000.

How is this reflected in the financial statements?

Solution to Illustration 2

The current balances in the accounts are:

Building cost $300,000

Accumulated depreciation $100,000

- The building asset account needs to be raised by $450,000 to $750,000.
- On revaluation, the accumulated depreciation account is cleared out.

Therefore the double-entry required is:

Dr Non-current asset – building $450,000

Dr Accumulated depreciation $100,000

Cr Revaluation surplus $550,000

The gain of $550,000 reflects the difference between the carrying amount pre-revaluation of $200,000 and the revalued amount of $750,000.

Extract from the statement of profit or loss and other comprehensive income: (covered in more detail later in the text).

Other comprehensive income: Item that will not be reclassified in subsequent accounting periods:

Gain on property revaluation in year $550,000

Asset (building)

	$		$
Balance b/f	300,000		
Revaluation surplus	450,000	Balance c/f	750,000
	750,000		750,000
Balance b/f	750,000		

Accumulated depreciation (building)

	$		$
Revaluation surplus	100,000	Balance b/f	100,000
	100,000		100,000

Revaluation surplus

	$		$
		Non-current asset (building)	450,000
Balance c/f	550,000	Accumulated depreciation (building)	100,000
	550,000		550,000
		Balance b/f	550,000

In summary

Revaluation surplus = Revalued amount – Carrying amount

For a non-depreciated asset:

Dr Non-current asset	revaluation surplus
Cr Revaluation surplus	revaluation surplus

Note that the revaluation surplus within equity is an accumulated revaluation surplus. The amount recognised within other comprehensive income is the revaluation surplus accounted for in that year.

For a depreciated asset:

Dr Accumulated depreciation	depreciation to date
Dr Non-current asset – cost	ß
Cr Revaluation surplus	revaluation gain

The revaluation gain for the year is disclosed on the face of the statement of profit or loss and other comprehensive income as an item of 'other comprehensive income'. This amount is added to any earlier revaluation from a previous accounting period to arrive at a cumulative revaluation surplus in the statement of changes in equity (SOCIE) and statement of financial position.

Test your understanding 3

MaxCo owns a fish finger factory. The premises were purchased on 1 January 20X1 for $450,000 and depreciation charged at 2% pa on a straight-line basis.

MaxCo now wishes to revalue the factory premises to $800,000 on 1 January 20X7 to reflect its market value.

What is the balance on the revaluation surplus account after accounting for this transaction?

A $350,000

B $395,000

C $404,000

D $413,000

4 Depreciation and disposal of a revalued asset

Depreciation of a revalued asset

- When a non-current asset has been revalued, the charge for depreciation should be based on the revalued amount and the remaining useful life of the asset.
- This charge will be higher than depreciation prior to the revaluation and will be charged to profit or loss as normal.
- IAS 16 says that **'if an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued'** (IAS 16, para 37).

- IAS 16 permits a class of assets to be revalued on a rolling basis, provided that the valuations are kept up to date and that they are performed within a short period.

  The excess of the new annual depreciation charge over the old depreciation charge may be the subject of an annual transfer from revaluation surplus to retained earnings (within the equity section of the statement of financial position) as follows:

  Dr Revaluation surplus $X

  Cr Retained earnings $X

In exam questions, you should review the question content carefully to determine whether this annual transfer is required. According to IAS 16 the annual transfer of excess depreciation is an optional policy decided upon by each entity that revalues any class of its property, plant and equipment. If the policy is adopted, then the transfer should be made every year. It is not permitted to make the transfer in some years and not in others.

Note: Retained earnings are the accumulated profits and losses of an entity that are reflected on the statement of financial position. This will be described in more detail later when the text considers company accounts.

e.g

Illustration 3 – Depreciation of a revalued asset

Esoteric owns a retail unit in central Springfield. It bought the property 25 years ago for $100,000, depreciating it over 50 years on a straight-line basis. At the start of 20X6 the entity decides to revalue the unit to $800,000. The unit has a remaining useful life of 25 years at the date of the revaluation. It is the entity's policy to make the annual transfer of excess depreciation between revaluation surplus and retained earnings within equity.

What accounting entries should be made in the financial statements for 20X6?

Solution to Illustration 3

Statement of profit or loss and other comprehensive income:

Other comprehensive income:

Items that will not be reclassified to profit or loss in future periods:

Revaluation surplus on property in the year $750,000

Statement of financial position:

On revaluation at start of 20X6

Dr Non-current asset – retail unit $700,000

Dr Accumulated depreciation $50,000

Cr Revaluation surplus $750,000

Depreciation for 20X6

Dr Depreciation expense ($800,000/25 yrs) $32,000

Cr Accumulated depreciation $32,000

Transfer of excess depreciation within equity for 20X6

Dr Revaluation surplus ($32,000 – $2,000) $30,000

Cr Retained earnings $30,000

Tutorial note: excess depreciation is the difference between the post-revaluation depreciation charge of $32,000 and the depreciation charge based upon original cost of $2,000.

Disposal of a revalued asset

IAS 16 says that **'the gain or loss arising from the derecognition of an item of property, plant and equipment shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item'** (IAS 16, para 71).

Additionally, IAS 16 says that **'the revaluation surplus included in equity in respect of an item of property, plant and equipment may be transferred directly to retained earnings when the asset is derecognised'** (IAS 16, para 41). This is achieved by taking the balance on the revaluation surplus account and transferring it to retained earnings which contains only realised gains and losses. If the entity no longer owns the asset because it has been disposed of, it is inappropriate to maintain a revaluation surplus account for that asset. Any balance on revaluation surplus at the disposal date has now been realised and should be transferred to retained earnings and disclosed in the statement of changes in equity ('SOCIE' – this is dealt with later in the text). The double-entry within equity is as follows:

Dr Revaluation surplus

Cr Retained earnings

Retained earnings are the sum total of all the profits and losses earned to date and is included within equity on the statement of financial position.

Test your understanding 4

Tiger Trees owns and runs a golf club. Some years ago the entity purchased land next to the existing course with the intention of creating a smaller nine-hole course. The cost of the land was $260,000. Over time the entity had the land revalued to $600,000. It has now decided that building the new course is uneconomical and has sold the land for $695,000.

What accounting entries are required to reflect the disposal?

5 IAS 16 disclosure requirements

Statement of financial position
Aggregate CV of non-current assets disclosed on the face of the statement of financial position

Statement of profit or loss
Depreciation charge included within relevant expense categories.

Notes to the accounts
- Disclosure of depreciation methods and rates used.
- Non-current assets disclosure.
- Details of revaluations.

According to IAS 16 *Property Plant and Equipment*, there are a number of disclosure requirements relating to non-current assets. The principal disclosure requirements include:

1 The measurement bases used for arriving at the carrying amount of the asset (e.g. cost or valuation). If more than one basis has been used, the amounts for each basis must be disclosed.

2 Depreciation methods used, with details of useful lives or the depreciation rates used.

3 The gross amount of each asset heading and its related accumulated depreciation (aggregated with accumulated impairment losses) at the beginning and end of the period.

4 A reconciliation of the carrying amount at the beginning and end of the period, showing:
   - additions
   - assets classified as held for sale
   - disposals
   - revaluations
   - depreciation.

5 Any commitments for future acquisition of property, plant and equipment.

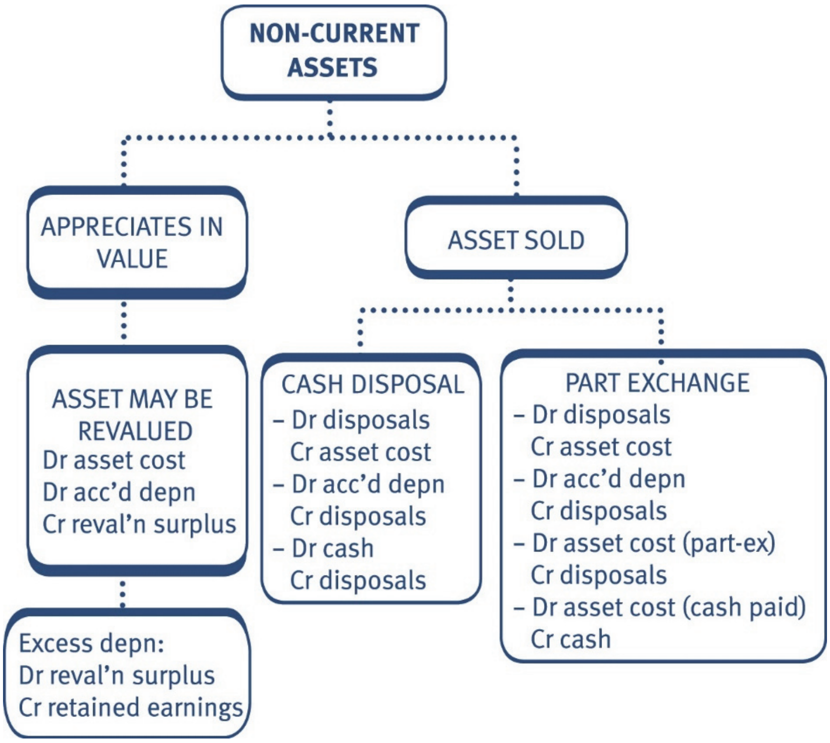
6 If assets are stated at revalued amounts, the following should be disclosed:
   - the effective date of the revaluation
   - whether an independent valuer performed the valuation
   - the methods and assumptions applied in estimating the items' fair value
   - the carrying amount that would have been recognised had the assets been carried at cost
   - the revaluation surplus, indicating the change for the period.

Note: Items (3) and (4) are often referred to as preparation of the movements schedule or grid for the year.

If there has been a revaluation of property, plant and equipment in the year, this may be performed by either an employee or director of the company, or by an independent third party. Who performed the valuation is regarded as relevant or useful information to those who make investment decisions based upon the content of the financial statements. If the valuation was performed by an employee or director of the company, although it is permitted by IAS 16, there is potential for objectivity to be compromised, and therefore details of the valuer should be disclosed in the notes to the financial statements. The movements schedule or grid is illustrated as follows:

	Land & bldgs	**Plant & equip't**	**Motor vehicles**	**Fixtures**	**Total**
Cost or valuation:	$000	$000	$000	$000	$000
Balance b/fwd	X	X	X	X	X
Additions	X	X	X	X	X
Revaluation in year	X	X	X	X	X
Disposals	(X)	(X)	(X)	(X)	(X)
Balance c/fd	X	X	X	X	X
Accumulated depreciation:					
Balance b/fwd	X	X	X	X	X
Charge for the year	X	X	X	X	X
Revaluation in year	(X)	(X)	(X)	(X)	(X)
Disposals	(X)	(X)	(X)	(X)	(X)
Balance c/fwd	X	X	X	X	X
Carrying amount c/fwd	**X**	**X**	**X**	**X**	**X**
Carrying amount b/fwd	**X**	**X**	**X**	**X**	**X**

6 Chapter summary



Test your understanding answers

Test your understanding 1

1 Dr Disposals $3,000

Cr Fixtures and fittings cost $3,000

2 Dr Accumulated depreciation $1,050

Cr Disposals $1,050

Depreciation working:

X2 10% × $3,000 × 11/12 = $275

X3 10% × $3,000 = $300

X4 10% × $3,000 = $300

X5 10% × $3,000 × 7/12 = $175

Total: $1,050

3 Dr Bank $2,000

Cr Disposals $2,000

Disposals

	$		$
31.7.X5 fixtures and fittings cost	3,000	Accumulated depreciation	1,050
Profit on disposal (ß)	50	Bank – cash proceeds	2,000
	3,050		3,050

The charge to the statement of profit or loss for the year ended 31 December 20X5 is:

Depreciation charge for the year	$175
(Profit)/loss on disposal	$(50)

Note: As depreciation is charged monthly, it is necessary to charge an amount to the statement of profit or loss for the period 1 January 20X5 to the disposal date 31 July 20X5.

Test your understanding 2

Sewing machine

	$		$
Balance b/f	2,500	Disposal	2,500
New asset PEA	750		
Bank	4,850	Balance c/f	5,600
	8,100		8,100
Balance b/f	5,600		

Accumulated depreciation (sewing machine)

	$		$
Disposal	1,500	Balance b/f	1,500
Balance c/f	1,120	Depreciation charge X5	1,120
	2,620		2,620
		Balance b/f	1,120

Depreciation b/f working:

$2,500 × 20% × 3 years = $1,500

Disposals

	$		$
Sewing machine cost	2,500	Sewing machine accumulated depreciation	1,500
		PEA	750
		Loss on disposal (ß)	250
	2,500		2,500

Depreciation charge

	$		$
Sewing machine Accumulated depreciation	1,120	Profit or loss	1,120

Depreciation charge working:

$5,600 × 20% = $1,120

Test your understanding 3

The correct answer is C

Non-current asset – factory

	$		$
Balance b/f	450,000		
Revaluation	350,000	Balance c/f	800,000
	800,000		800,000
Balance b/f	800,000		

Accumulated depreciation (factory)

	$		$
Revaluation (2% × $450,000 × 6 years)	54,000	Balance b/f	54,000
	54,000		54,000

Revaluation surplus

	$		$
		Factory asset	350,000
Balance c/f	404,000	Accumulated depreciation	54,000
	404,000		404,000
		Balance b/f	404,000

Test your understanding 4

Land (valuation)

	$		$
Original cost	260,000		
Revaluation surplus	340,000	Balance c/f	600,000
	–––––––		–––––––
	600,000		600,000
	–––––––		–––––––
Bal b/f	600,000	Disposals	600,000
	–––––––		–––––––

Revaluation surplus

	$		$
Retained earnings	340,000	Land	340,000
	–––––––		–––––––

Bank

	$		$
NCA Disposal	695,000		

NCA Disposal

	$		$
Land	600,000	Bank	695,000
Gain on disposal	95,000		

Note that the gain on disposal is included in the statement of profit or loss in arriving at the profit for the year.

Retained earnings

	$		$
		Revaluation surplus	340,000

Chapter

8

Intangible assets

Chapter learning objectives

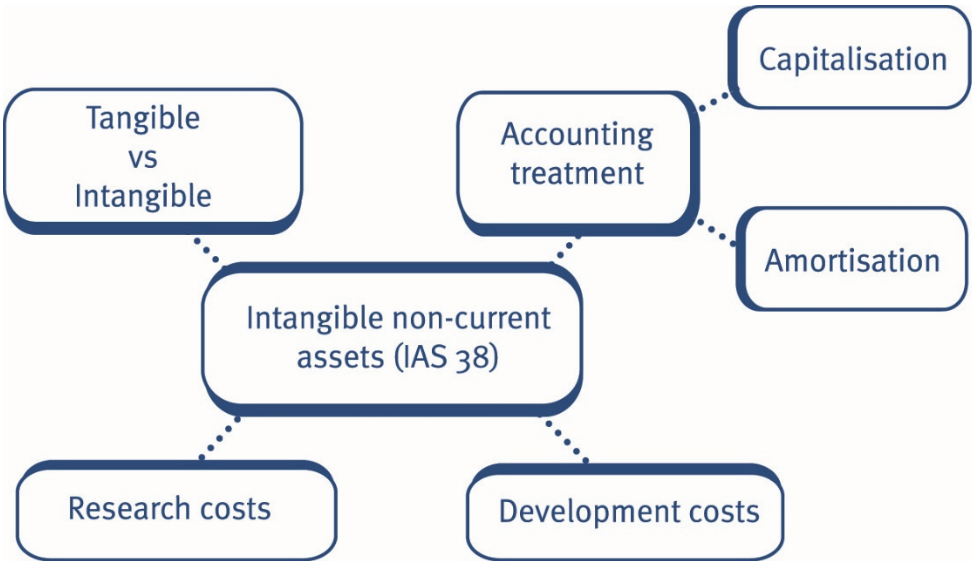
Upon completion of this chapter you will be able to:

- recognise the difference between tangible and intangible non-current assets
- define and explain the treatment of research costs and development costs in accordance with IAS 38
- calculate the amounts to be capitalised as asset expenditure or expensed with regard to research and development
- explain the purpose of, calculate and account for amortisation of intangible assets.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter deals with the definition of intangible assets, before going on to consider how they are recognised and measured in the financial statements in accordance with IAS 38 *Intangible Assets*.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies, in particular for Financial Reporting and Strategic Business Reporting.

2 Intangible Assets (IAS 38)

Non-current assets are assets used within the business on an ongoing basis in order to generate revenue.

IAS 38 *Intangible Assets* defines an intangible asset as **'an identifiable non-monetary asset without physical substance'** (IAS 38, para 8). In particular, the key characteristics of an intangible non-current asset are as follows:

- it is a resource controlled by the entity as a result of past events from which the entity expects to derive future economic benefits,
- it lacks physical substance, and
- it is identifiable and separately distinguishable from goodwill.

The basic principle of recognition of an intangible asset in the financial statements is that **'the asset meets**

- **the definition of an intangible asset, and**
- **the recognition criteria'** (IAS 38, para 18).

As with any asset, it should be capable of reliable measurement and it is probable that future economic benefits will be received over the useful life of the asset.

Development costs are internally generated intangible assets which are capitalised as asset expenditure provided that specified criteria have been complied with. They are considered elsewhere within this chapter.

Assets

Tangible non-current assets	Intangible non-current assets
Normally have physical substance, e.g land and buildings.	Do not normally have physical substance, e.g. copyright.
Normally involve expenditure being incurred.	Can be purchased or may be created within a business without any expenditure being incurred, i.e. internally generated, e.g. brands.
Cost of the tangible non-current asset is capitalised.	Purchased intangible non-current assets are capitalised. Generally, internally generated assets may not be capitalised.
Depreciation is a reflection of the wearing out of the asset.	Amortisation is a reflection of the wearingout of the (capitalised) asset.
	Examples: • Development costs • Goodwill • Trade marks • Licences • Patents • Copyrights • Franchises

Test your understanding 1

Willis Ltd purchased a patent, with a useful life of ten years for $20,000 on 1 January 20X9.

Prepare extracts of the financial statements for the year ended 31 December 20X9?

3 Research and development

IAS 38 contains specific requirements relating to accounting for research and development activities. First, it is necessary to understand the definition of research expenditure and development costs before their respective accounting treatment is considered.

IAS 38 defines research as **'original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding'** (IAS 38, para 8).

Development is defined as **'the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use'** (IAS 38, para 8).

Accounting treatment of research and development

When an entity undertakes research and development activity, expenditure is incurred with the intention of producing future economic benefits i.e. increased sales revenues and profits.

The accounting issue is therefore whether these costs should be expensed to the statement of profit or loss or capitalised as an intangible asset on the statement of financial position to match against future benefits arising.

Research

- All research expenditure should be written off to the statement of profit or loss as it is incurred. This is in compliance with the prudence concept.
- Research expenditure does not directly lead to future benefits and therefore it is not possible to follow the matching concept.
- Any expenditure on research equipment (property, plant and equipment) should be recognised as asset expenditure and depreciated as normal in accordance with IAS 16.

Development costs

- According to IAS 38 *Intangible Assets*, development costs must be capitalised as an intangible asset if they meet the definition of an intangible asset and also meet the recognition criteria. Typically, this will apply if the following criteria are met:
  - **P**robable inflow of economic benefit from the asset, whether through sales or internal cost savings
  - **I**ntention to complete the asset and to use it or sell it
  - **R**eliable measurement of development costs
  - **A**dequate financial and other resources to complete the project

 – **T**echnical feasibility to complete the asset, so that it will be available for use or sale
 – **E**xpected to be profitable – the costs of the project will be exceeded by the benefits generated.

- If the above criteria are not met, development expenditure must be written off to the statement of profit or loss as it is incurred.
- If research expenditure has been treated as an expense, it cannot subsequently be reinstated as an asset.

Subsequent treatment of development expenditure

- The asset should be amortised over the period that is expected to benefit. This ensures that costs are matched to the revenue in the statement of profit or loss.
- Amortisation should commence with commercial production and charged over the period over which the business expects to generate economic benefits.
- Each project should be reviewed at the year end to ensure that the 'PIRATE' criteria are still met. If they are no longer met, the previously capitalised asset expenditure must be written off to the statement of profit or loss immediately.

If a policy of recognising asset expenditure is adopted, it should be applied to all projects that meet the criteria.

IAS 38 Amortisation of intangible assets

Amortisation of an intangible asset

If the useful life of an intangible asset is finite, the development costs must be amortised once commercial exploitation begins.

The amortisation method used should reflect the pattern in which the asset's economic benefits are consumed by the enterprise. If that pattern cannot be determined reliably, the straight-line method should be used.

An intangible asset with an indefinite useful life should not be amortised. An asset has an indefinite useful life if there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the business. Instead, it should be subject to an annual impairment review.

Illustration 1 – Accounting for development costs

Brightspark Co is developing a new product, the widget. This is expected to be sold over a three-year period starting in 20X6. The forecast data is as follows:

	20X5	20X6	20X7	20X8
	$000	$000	$000	$000
Net revenue from other activities	400	500	450	400
Net revenue from widgets	–	450	600	400
Development costs	(900)	–	–	–

Show how the development costs should be treated if:

(a) **the costs do not qualify for capitalisation**

(b) **the costs do qualify for capitalisation and are amortised on a straight-line basis.**

Solution to Illustration 1

(a) **Profit treating development costs as expenses when incurred**

	20X5	20X6	20X7	20X8
	$000	$000	$000	$000
Net revenue from other activities	400	500	450	400
Net revenue from widgets	–	450	600	400
Development costs	(900)	–	–	–
Net profit/(loss)	(500)	950	1,050	800

(b) **Net profit amortising development costs over life of widgets**

	20X5	20X6	20X7	20X8
	$000	$000	$000	$000
Net revenue from other activities	400	500	450	400
Net revenue from widgets	–	450	600	400
Development costs amortised	–	(300)	(300)	(300)
Net profit	400	650	750	500

Note that amortisation is spread over the period over which economic benefits are expected to be received.

Test your understanding 2

Which of the following should be classified as development costs?

1 Braynee Co has spent $300,000 investigating whether a particular substance, flubber, found in the Amazon rainforest is resistant to heat.

2 Cleverclogs Co has incurred $120,000 expenses in the course of making a new waterproof and windproof material with the idea that it will be used for ski-wear.

3 Ayplus Co has found that a chemical compound, known as XYX, is not harmful to the human body.

4 Braynee Co has incurred a further $450,000 using flubber in creating prototypes of a new heat-resistant suit for stuntmen.

A All of them

B 1 and 3

C 2 and 4

D 2 only

Test your understanding 3

During the current year, Deep Blue Sea developed a new material from which the next generation of wetsuits will be made. This special material will ensure that swimmers are kept warmer than ever. The costs incurred meet the criteria to be classified as asset expenditure and by 31 December 20X5 year-end $250,000 have been recognised as asset expenditure.

The wetsuits are expected to generate revenue for five years from the date that commercial production commences on 1 January 20X6.

What amount is charged to the statement of profit or loss in the year ended 31 December 20X6?

A Nil

B $250,000

C $100,000

D $50,000

4 Measurement of intangible assets

Initial recognition and measurement

IAS 38 *Intangible Assets* says that **'an intangible asset shall be measured initially at cost'** (IAS 38, para 24).

Subsequent measurement

IAS 38 permits either the cost model or the valuation model to be used for subsequent measurement. If the cost model is applied, an intangible asset **'shall be carried at its cost, less any accumulated amortisation and any accumulated impairment losses'** (IAS 38, para 74).

For the valuation model to be applied, **'fair value should be measured by reference to an active market'** (IAS 38, para 75). In effect, this requires the intangible assets to be homogeneous (i.e. identical) in nature. This is very rarely the case and therefore, to all intents and purposes, intangible assets are accounted for using the cost model. In practical terms, development costs would not meet the criteria for the valuation model to apply and the cost model should always be applied.

In rare situations where the valuation model can be applied, in a similar way to IAS 16 dealing with revaluation of property, plant and equipment, any upward revaluation is recorded as an item of other comprehensive income for the year and taken to a separate revaluation surplus for intangible assets within equity on the statement of financial position.

5 IAS 38 disclosure requirements

According to IAS 38, *Intangible Assets*, the financial statements should disclose the following for development costs and other intangible assets:

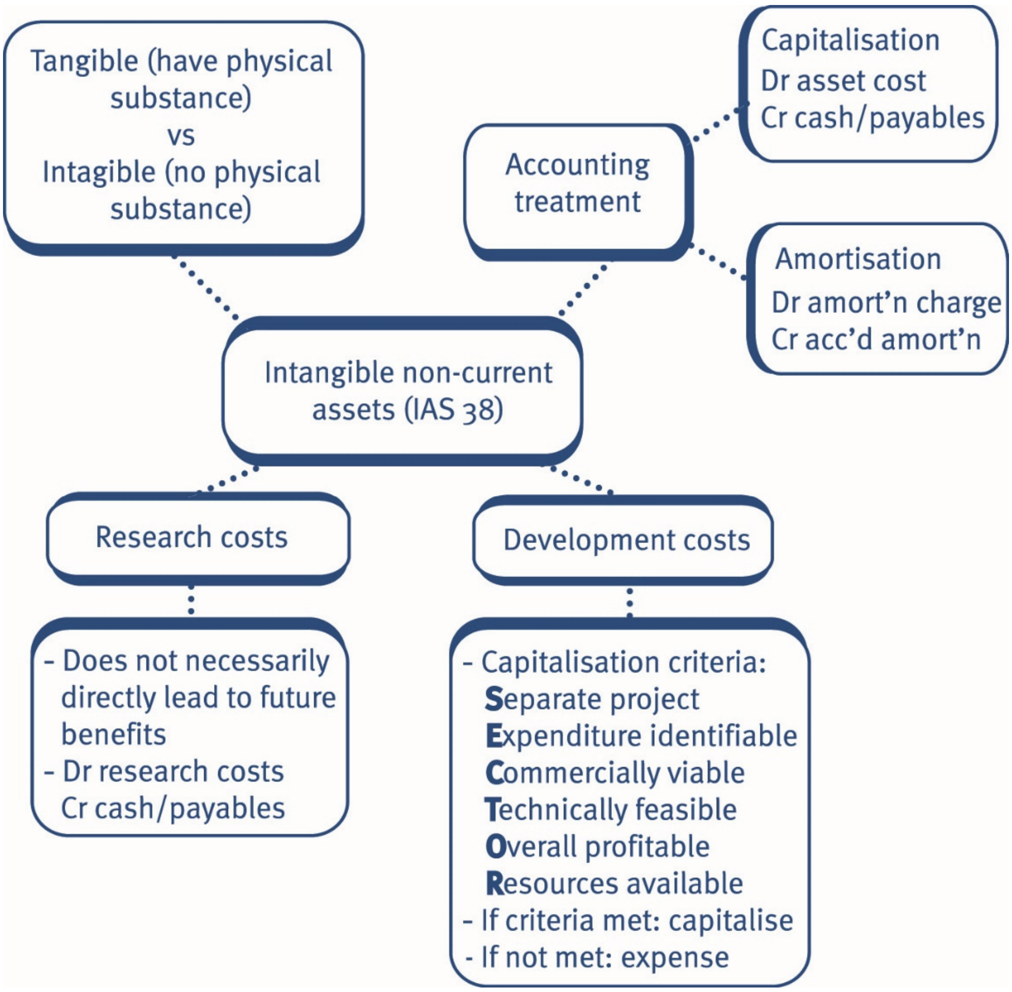
- the amortisation method used and the expected period of amortisation
- a reconciliation of the carrying amounts at the beginning and end of the period, showing new expenditure incurred, amortisation and amounts written off because a project no longer qualifies for recognition to be classified as asset expenditure
- amortisation during the period.

In addition, the financial statements should also disclose the total amount of research and development expenditure recognised as an expense during the period.

The reconciliation of the carrying amount for intangible assets from the start of the year to the end of the year required by IAS 38 is similar to that required for property, plant and equipment in accordance with IAS 16 as follows:

	Development costs	**Licences**	**Total**
Cost or valuation:	$000	$000	$000
Balance b/fwd	X	X	X
Additions	X	X	X
Disposals	(X)	(X)	(X)
Balance c/fwd	X	X	X
Accumulated depreciation:	X	X	X
Balance b/fwd	X	X	X
Charge for the year	(X)	(X)	(X)
Disposals	X	X	X
Carrying amount 31 Dec 20X4	**X**	**X**	**X**
Carrying amount 31 Dec 20X3	**X**	**X**	**X**

6 Chapter summary



Test your understanding answers

Test your understanding 1	
Statement of profit or loss	
Amortisation	$2,000
($20,0000/10 years)	
Statement of financial position extract	
Intangible assets	$18,000
($20,000 – $2,000)	

Test your understanding 2

The correct answer is C

Both 1 and 3 involve researching materials, without any form of commercial production in mind.

Test your understanding 3

The correct answer is D

Amortisation will be charged on a straight-line basis for each of the five years that revenue is generated.

Therefore the amortisation charge for each of the years ended 31 December 20X6 – 20Y0 will be:

$250,000/5 years = $50,000

Chapter

9

Accruals and prepayments

Chapter learning objectives

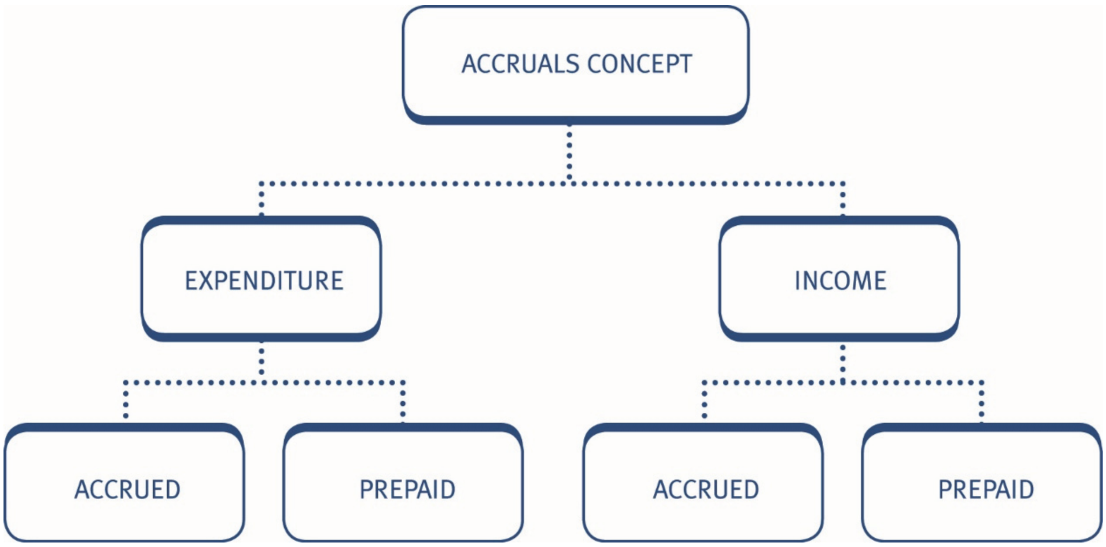
Upon completion of this chapter you will be able to:

- understand how the matching concept applies to accruals and prepayments
- identify and calculate adjustments relating to accruals and prepayments
- record the appropriate adjustments for accruals and prepayments in the ledger accounts
- understand the impact of accruals and prepayments on profit and net assets.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter considers the accruals basis of accounting and the accounting entries required prepare financial statements on that basis.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies, in particular for Financial Reporting.

2 Accruals basis of accounting

The accruals basis of accounting means that to calculate the profit for the period, we must include all the income and expenditure relating to the period, whether or not the cash has been received or paid or an invoice received.

Profit is therefore:

Income earned	$X
Expenditure incurred	$(X)
	——
Profit	$X

Accruals concept

The Conceptual Framework explains accruals accounting as 'depicting the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims in the accounting period(s) in which those effects occur'. This will be the case, even if cash receipts and payments arise in different reporting periods.

The accruals concept is identified as an important accounting concept by IAS 1 Presentation of Financial Statements as it provides a better basis for assessing financial performance, rather than relying solely upon information relating to cash receipts and payments.

Therefore all of the expenses involved in making the sales for a period should be matched with the sales income and dealt with in the period in which the sales themselves are accounted for.

Sales revenue

The sales revenue for an accounting period is included in the statement of profit or loss when the sales are made. This means that, when a sale is made on credit, it is recognised when the agreement is made and the invoice is sent to the customer rather than waiting until the cash for the sale is received. This is done by setting up a receivable in the statement of financial position for the amount of cash that is due from the sale (debit receivables and credit sales revenue).

Purchases

Similarly purchases are matched to the period in which they were made by accounting for all credit purchases when they took place and setting up a payable in the statement of financial position for the amount due (debit purchases and credit payables).

Cost of sales

The major cost involved in making sales in a period is the actual cost of the goods that are being sold. As we saw in a previous chapter, we need to adjust for opening and closing inventory to ensure that the sales made in the period are matched with the actual costs of those goods. Any goods unsold are carried forward to the next period so that they are accounted for when they are actually sold.

Expenses

The expenses of the period that the business has incurred in making its sales, such as rent, electricity and telephone, must also be matched with the sales for the period. This means that the actual expense incurred in the period should be included in the statement of profit or loss rather than simply the amount of the expense that has been paid in cash.

3 Accrued expenditure

An accrual arises where expenses of the business, relating to the year, have not been paid by the year end. This will reduce profit for the year.

In this case, it is necessary to record the extra expense relevant to the year and create a corresponding statement of financial position liability (called an accrual):

Dr Expense account $X

Cr Accrual $X

Illustration 1 – Accrued expenditure

A business' electricity charges amount to $12,000 pa. In the year to 31 December 20X5, $9,000 has been paid. The electricity for the final quarter is paid in January 20X6.

What year-end accrual is required and what is the electricity expense for the year?

Show the relevant entries in the ledger accounts.

Solution to Illustration 1

- The total expense charged to the statement of profit or loss in respect of electricity should be $12,000.
- The year-end accrual is the $3,000 expense that has not been paid in cash.
- The accounting entries required are:

  Dr Electricity expense $3,000

  Cr Accruals $3,000

Ledger accounts and accrued expenses

Method 1: know the accrual

Electricity expense

	$		$
Bank	9,000	Profit or loss (ß)	12,000
Accrual c/f	3,000		
	12,000		12,000
		Accrual b/f	3,000

Method 2: know the statement of profit or loss charge

Electricity expense

	$		$
Bank	9,000	Profit or loss	12,000
Accrual c/f (ß)	3,000		
	12,000		12,000
		Accrual b/f	3,000

Test your understanding 1

Jarah's business has an accounting year end of 31 December 20X1. Jarah rents factory space at a rental cost of $5,000 per quarter, payable in arrears.

During the year to 31 December 20X1 payments of rent were made as follows:

- 31 March (for the quarter to 31 March 20X1) $5,000
- 29 June (for the quarter to 30 June 20X1) $5,000
- 2 October (for the quarter to 30 September 20X1) $5,000

The final payment due on 31 December 20X1 for the quarter to that date was not paid until 4 January 20X2.

Show the ledger accounts required to record the above transactions.

Accrued expenditure will reduce profit in the statement of profit or loss and will also create a current liability on the statement of financial position.

For example, if we were to put through an accrual of $500 for telephone expenses. The accounting entries would be:

Dr Telephone expenses $500

Cr Accruals $500

The additional telephone expense would reduce profits by $500. The additional accrual would increase current liabilities by $500.

4 Prepaid expenditure

A prepayment arises where some of the following year's expenses have been paid in the current year.

In this case, it is necessary to remove that part of the expense which is not relevant to this year and create a corresponding statement of financial position asset (called a prepayment):

Dr Prepayment $X

Cr Expense account $X

A prepayment will therefore increase profit in the statement of profit or loss.

Illustration 2 – Prepaid expenditure

The annual insurance charge for a business is $24,000 pa. $30,000 was paid on 1 January 20X5 in respect of future insurance charges.

For the year-ended 31 December 20X5 what is the closing prepayment and the insurance expense for the year?

Show the relevant entries in the ledger accounts.

Solution to Illustration 2

- The total expense charged to the statement of profit or loss in respect of insurance should be $24,000.
- The year-end prepayment is the $6,000 that has been paid in respect of 20X6.

The accounting entries required are:

Dr Prepayment $6,000

Cr Insurance expense $6,000

Insurance – expense

	$		$
Bank	30,000	Profit or loss	24,000
		Prepayments c/f	6,000
	30,000		30,000

Test your understanding 2

Eisa pays the rental expense on a market stall in advance. Eisa started business on 1 January 20X5 and on that date paid $1,200 in respect of the first quarter's rent. During the first year of trade, Eisa also paid the following amounts:

- 3 March (in respect of the quarter ended 30 June) $1,200
- 14 June (in respect of the quarter ended 30 September) $1,200
- 25 September (in respect of the quarter $1,400 ended 31 December)
- 13 December (in respect of the first quarter of 20X6) $1,400

Show these transactions in the rental expense account.

Prepaid expenditure increases profit on the statement of profit or loss and also creates a current asset to be included on the statement of financial position.

For example, if we were to include a prepayment of $1,000 in our financial statements for insurance, the accounting entries would be:

Dr Prepayments $1,000

Cr Insurance expense $1,000

The prepayments side would increase our current assets by the $1,000. The insurance expense would decrease by the $1,000, and hence increase our overall profits.

Proforma expense T-account

Expense

	$		$
Balance b/f (opening prepaid expense)	X	Balance b/f (opening accrued expense)	X
Bank (total paid during the year)	X	Profit or loss (total expense for the year)	X
Balance c/f (closing accrued expense)	X	Balance c/f (closing prepaid expense)	X
	X		X
Balance b/f (opening prepaid expense)	X	Balance b/f (opening accrued expense)	X

Notes to support the proforma

- There may be a debit balance brought forward (opening prepayment) or a credit balance brought forward (an accrual).
- Payments made during the year are debited to the expense account.
- If there is an accrual required at the end of the year, this is debited to the expense account (to increase the charge to profit or loss) and which is also carried forward at the end of the year as a credit balance.
- If there is a prepayment required at the end of the year, this is credited to the expense account (to reduce the charge to profit or loss) and which is also carried forward at the end of the year as a debit balance.
- In an expense account, there will be more debits than credits; when the account is balanced off, the net debit balance is taken to profit or loss for the year.

Test your understanding 3

On 1 January 20X5, Kairo owed $2,000 in respect of the previous year's electricity. Kairo made the following payments during the year ended 31 December 20X5:

- 6 February $2,800
- 8 May $3,000
- 5 August $2,750
- 10 November $3,100

At 31 December 20X5, Kairoy calculated that $1,800 was owed in respect of electricity for the last part of the year.

What is the electricity charge to the statement of profit or loss?

A $1,800

B $11,450

C $11,650

D $13,450

5 Accrued income

Accrued income arises where income has been earned in the accounting period but has not yet been received.

In this case, it is necessary to record the extra income in the statement of profit or loss and create a corresponding asset in the statement of financial position (called accrued income):

Dr Accrued income (SFP) $X

Cr Income (P/L) $X

Accrued income creates an additional current asset on our statement of financial position. It also creates additional income on our statement of profit or loss, and hence this will increase overall profits.

Illustration 3 – Accrued income

A business earns bank interest income of $300 per month. $3,000 bank interest income has been received in the year to 31 December 20X5.

What is the year-end asset and what is the bank interest income for the year?

Show the relevant entries in the ledger accounts.

Solution to Illustration 3

- The total amount credited to the statement of profit or loss in respect of interest should be $3,600 (12 × $300).
- The year-end accrued income asset is the $600 that has not yet been received.

The accounting entries required are:

Dr Accrued income (SFP) $600

Cr Bank interest income (P/L) $600

Bank interest income

	$		$
Profit or loss	3,600	Bank	3,000
		Accrued income c/f	600
	3,600		3,600

Accrued income (SFP Asset)			
	$		$
Bank interest income	600		

6 Prepaid income

Prepaid income arises where income has been received in the accounting period but which relates to the next accounting period.

In this case, it is necessary to remove the income not relating to the year from the statement of profit or loss and create a corresponding liability in the statement of financial position (called prepaid income):

Dr Income (P/L) $X

Cr Prepaid Income (SFP) $X

Illustration 4 – Prepaid income

A business rents out a property at an income of $4,000 per month. $64,000 has been received in the year ended 31 December 20X5.

What is the year-end liability and what is the rental income for the year?

Show the relevant entries in the ledger accounts.

Solution to Illustration 4

- The total amount credited to the statement of profit or loss in respect of rent should be $48,000 (12 × $4,000).
- The year-end prepaid income liability is the $16,000 ($64,000 – $48,000) that has been received in respect of next year.

The accounting entries required are:

Dr Rental income $16,000

Cr Prepaid income (SFP) $16,000

Rental income			
	$		$
Profit or loss	48,000	Bank	64,000
Prepaid income c/f	16,000		
	64,000		64,000
		Accrued income b/f	16,000

Prepaid income (SFP liability)			
	$		$
		Rental income	16,000

Prepaid income reduces income in the statement of profit or loss for the current reporting period and hence reduces overall profit. It also creates a current liability in the statement of financial position as it is income received but which has not yet been earned and should not therefore be recognised in the statement of profit or loss until a subsequent accounting period.

Proforma income T-account

Income			
	$		$
Balance b/f (opening accrued income)	X	Balance b/f (opening prepaid income)	X
Profit or loss (total revenue for the year)	X	Bank (total received during the year)	X
Balance c/f (closing prepaid income)	X	Balance c/f (closing accrued income)	X
	X		X
Balance b/f (opening accrued income)	X	Balance b/f (opening prepaid income))	X

Notes to support the proforma

- There may be a debit balance brought forward (opening accrued income) or a credit balance brought forward (opening prepaid income).
- Receipts received during the year are credited to the income account.
- If there is closing accrued income at the end of the year, this is credited to the income account (to increase income in profit or loss for the year) and which is also carried forward at the end of the year as a debit balance.
- If there is closing prepaid income at the end of the year, this is debited to the income account (to reduce income in profit or loss for the year) and which is also carried forward at the end of the year as a credit balance.
- In an income account, there will be more credits than debits; when the account is balanced off, the net credit balance is taken to profit or loss for the year.

Test your understanding 4

Accrued and prepaid income

Libby Farquar receives income from two rental units as follows:

	Unit 1		Unit 2	
Period	**$**	**Received**	**$**	**Received**
1.10.X4 – 31.12.X4	2,150	30.9.X4	1,300	2.1.X5
1.1.X5 – 31.3.X5	2,150	27.12.X4	1,300	4.4.X5
1.4.X5 – 30.6.X5	2,150	25.3.X5	1,300	1.7.X5
1.7.X5 – 30.9.X5	2,200	21.6.X5	1,400	6.10.X5
1.10.X5 – 31.12.X5	2,200	21.9.X5	1,400	2.1.X6
1.1.X6 – 31.3.X6	2,200	29.12.X5	1,400	4.4.X6

What is Libby's rental income in the statement of profit or loss for the year ended 31 December 20X5?

A $5,400

B $8,700

C $14,000

D $14,100

7 Accruals and prepayments in the statement of financial position

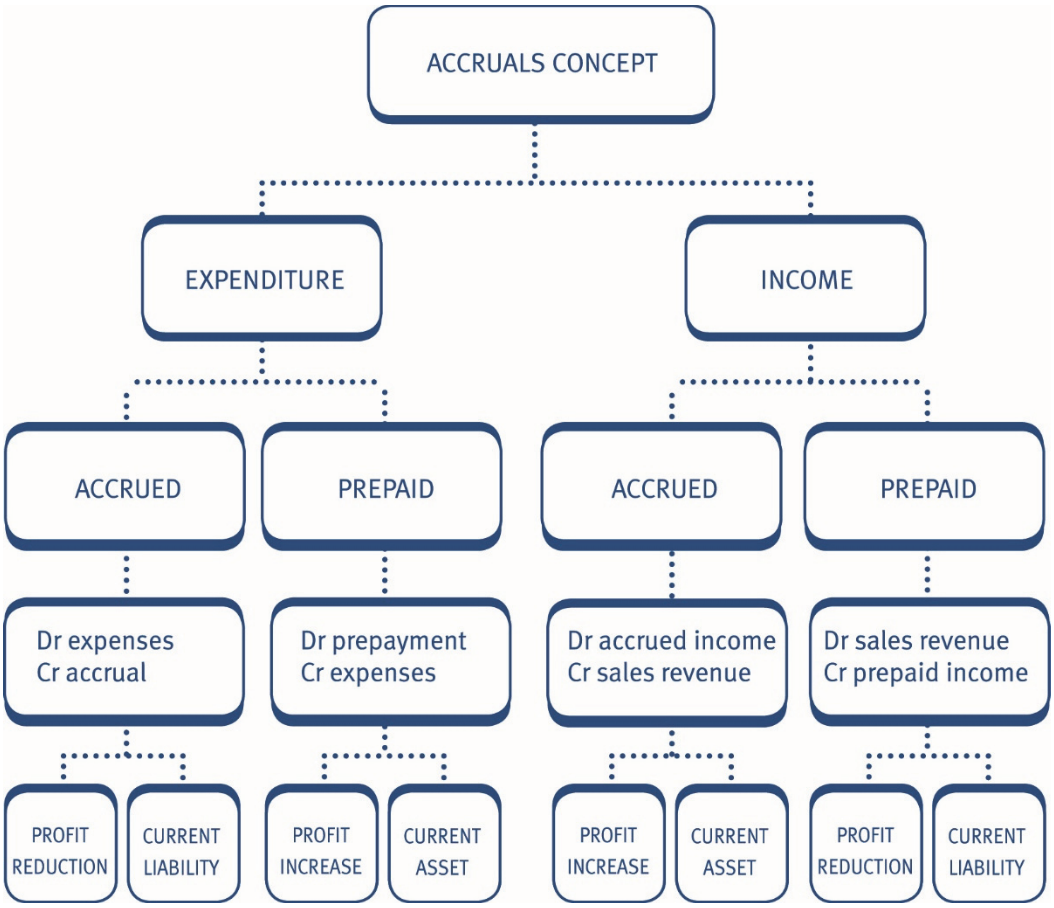
Prepayments are classified within trade and other receivables within current assets in the statement of financial position. Accruals are classified within trade and other payables within current liabilities in the statement of financial position.

The following illustration shows where prepayments and accruals are presented in the statement of financial position.

Current assets:	**$**	**Current liabilities:**	**$**
Inventories	X	Trade and other payables	X
Trade and other receivables	X	Bank overdraft	X
Cash at bank and in hand	X		
	X		X

Within the supporting disclosure notes to the annual financial statements, there is normally a breakdown of what constitutes the major components of trade and other receivables and also trade and other payables. If either prepayments or accruals were considered to be material, they could be separately disclosed within current assets and current liabilities respectively.

8 Chapter summary



Test your understanding answers

Test your understanding 1

Rental expense

	$		$
31 March Bank	5,000		
29 June Bank	5,000		
2 October Bank	5,000		
Accrual c/f	5,000	Profit or loss	20,000
	20,000		20,000
		Accrued b/f	5,000

Test your understanding 2

Rental expense

	$		$
1 January Bank	1,200		
3 March Bank	1,200		
14 June Bank	1,200		
25 September Bank	1,400	Profit or loss	5,000
13 December Bank	1,400	Prepayment c/f	1,400
	6,400		6,400
Prepayment b/f	1,400		

Test your understanding 3

The correct answer is B

Electricity expense

	$		$
6 February Bank	2,800	Accrual b/f	2,000
8 May Bank	3,000		
5 August Bank	2,750		
10 November Bank	3,100	Profit or loss	11,450
Accrual c/f	1,800		
	13,450		13,450
		Accrual b/f	1,800

Test your understanding 4

The correct answer is D

Rental income (Unit 1)

	$		$
		Prepaid income b/f	2,150
		25.3.X5 Bank	2,150
		21.6.X5 Bank	2,200
Profit or loss	8,700	21.9.X5 Bank	2,200
Prepaid income c/f	2,200	29.12.X5 Bank	2,200
	10,900		10,900
		Prepaid income b/f	2,200

Rental income (Unit 2)

	$		$
Accrued income b/f	1,300	2.1.X5 Bank	1,300
		4.4.X5 Bank	1,300
		1.7.X5 Bank	1,300
Profit or loss	5,400	6.10.X5 Bank	1,400
		Accrued income c/f	1,400
	6,700		6,700
Accrued income b/f	1,400		

Total income: $8,700 + $5,400 = $14,100

Chapter

10

Receivables

Chapter learning objectives

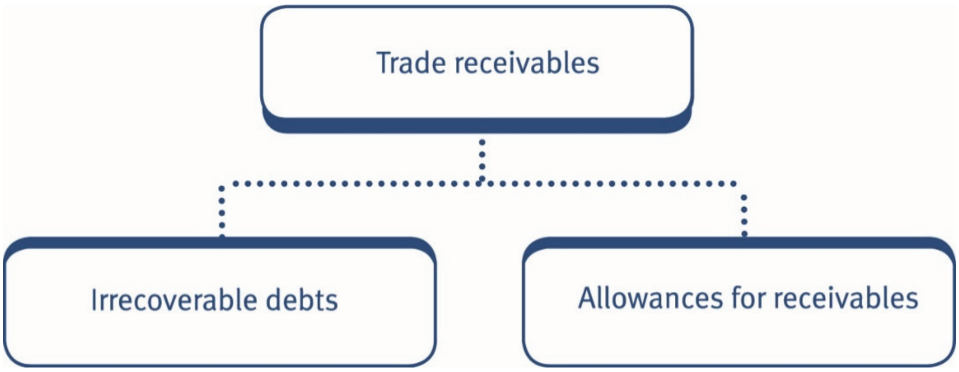
Upon completion of this chapter you will be able to:

- explain and identify examples of receivables
- understand the purpose of aged receivables analysis
- record the adjustments in the ledger accounts to write off an irrecoverable debt and one that is consequently recovered
- record the adjustments in the ledger accounts to adjust the allowance for receivables
- identify the impact of the above adjustments on profits and net assets.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter introduces the accounting requirements relating to irrecoverable debts and allowances for receivables that may not be fully recovered.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies, in particular for Financial Reporting.

Examples of receivables include those arising from credit sales ('trade receivables'), refunds of sales tax or business income tax and successful claims made against insurance policies agreed by the insurance company but not yet settled.

2 Trade receivables in the general ledger

The trade receivables' general ledger account normally includes the following entries:

Trade receivables

	$		$
Balance b/f	X	Sales returns	X
Credit sales	X	Cash at bank	X
Bank – dishonoured cheques (1)	X	Irrecoverable debts	X
Bank – refunds of credit balances (2)	X	Contra with payables ledger (4)	X
Interest charged (3)	X	Balance c/f	X
	X		X
Balance b/f (5)	X		

Numbered items above can be clarified as follows:

1 1If a payment from a credit customer has been declined by their bank, the trade receivables and cash at bank ledger accounts must be corrected to reflect the fact that the payment has not, in fact, been received and that the amount is still outstanding.

2 If a customer made an overpayment to settle an amount due, the overpayment should be returned to that customer. That will require a bank payment and adjustment in the trade receivables' general ledger account.

3 Some businesses may try to charge their customers interest on overdue amounts. If that is done, this will increase the amount owing from that customer and also increase interest received in the statement of profit and loss.

4 A business may both sell to, and buy from, another business on credit terms. If that is the case, each business will have amounts owing both to and from each other. Rather than make payments in full to each other, the two businesses may agree to offset (or 'contra') an agreed amount against balances due to each other. This will have the effect of reducing both the trade receivables' and trade payables' general ledger accounts in each business. The following accounting entries will have the effect of reducing both the trade receivables' and trade payables' general ledger accounts in each business:

Debit:	Payables ledger	\$X
Credit:	Receivables ledger	\$X

5 The closing balance at the end of an accounting period is the balance which will be included in the statement of financial position compiled at that date.

Remember that, as the general ledger accounts are updated, the memorandum-only customer accounts will also be updated at the same time using the same information. Therefore, there will be no differences between the trade receivables general ledger account and the total of the memorandum-only individual customer accounts balances.

3 Cash and credit sales

If a cash sale occurs, the customer pays for the goods/services at the point of sale. Assuming that the receipt is immediately banked, the accounting entries for a cash sale are:

Dr Cash at bank	\$X
Cr Sales revenue	\$X

If the sale is on credit terms, the customer will pay for the goods/services after receiving them. Typically, trading terms allow customers 30 – 60 days when purchasing goods and services on credit.

Under the accruals concept, the sale is recorded in the general ledger accounts when the right to the income is earned. That is usually the point at which the goods/services are delivered. Therefore, when sales are made on credit the revenue is recorded with a corresponding asset that represents the customer's commitment to pay. The asset is referred to as a 'trade receivable'.

The accounting entries to record the sale of goods on credit are:

Dr Trade receivables	$X
Cr Sales revenue	$X

At the same time the sale is recorded in the general ledger, the memorandum-only trade receivable account for that customer will also be updated.

When the customer subsequently settles the amount due, the accounting entries in the general ledger will be:

Dr Cash at bank	$X
Cr Trade receivables	$X

This removes the trade receivable from the general ledger. At the same time, the cash receipt will be recorded in the individual account for that customer.

The provision of credit facilities

Unless it is a retail business, the majority of businesses sell to their customers on credit and state a defined period within which the customer must pay (a credit period). The main benefits and costs of selling on credit are as follows:

Benefits to the business

- The business may be able to enter new markets.
- There is a possibility of increased sales.
- Customer loyalty may be encouraged.

Costs to the business

- Since the business is accepting payment at a later date, offering credit can be costly due to interest lost through not receiving the cash immediately.
- Cash flow of the business may deteriorate.
- The time and cost to follow-up on individual credit customers to request payment when it becomes overdue
- There is a risk of incurring an irrecoverable debt.

Aged receivables analysis

Where credit facilities are offered to customers, a business needs to review and manage the individual customer accounts which have been granted credit. One report from the accounting system which assists this is an aged receivables analysis. This report is based upon the individual account balances from the receivables' ledger and classifies amounts outstanding based upon how long they have been outstanding. The business can then focus its attention to those amounts which are overdue or due for payment.

Common features of the analysis report include:

- it is usually a list, ordered by name, showing how much each customer owes and how old their debts are
- the credit control function of a business uses the analysis to keep track of outstanding debts and follow up any that are overdue
- timely collection of debts improves cash flow and reduces the risk of debts becoming irrecoverable.

Credit limits

It is also normal for a business to set a credit limit for each credit customer. This is the maximum amount of credit that the business is willing to provide.

The use of credit limits may:

- reduce the risk to business of irrecoverable debts by limiting the amount sold on credit
- help to build up the trust of a new customer
- be part of the credit control strategy of a business.

4 Irrecoverable debts and allowances

The accruals concept dictates that when a sale is made, it is recognised in the financial statements, regardless of whether or not the payment has been received. Occasionally customers either refuse to pay or cannot settle their outstanding debts. Not only does this lead to a loss of income for a business, it also means that it may have an asset in its statement of financial position that it is unlikely to be able to collect.

If it is highly unlikely that the amount owed by a customer will be received, then this debt is known as an irrecoverable debt. Irrecoverable debts are 'written off' by removing them from the general ledger and from the receivable account of the individual customer. This course of action would be necessary if a customer was subject to formal insolvency proceedings and it was expected that the outstanding debt will not be recovered.

If there is concern over whether a customer will pay but there is still hope that the amount (or at least some of it) can be recovered, then an 'allowance' is created. Unlike an irrecoverable debt, these items are left in the general ledger and the individual customer account, but a separate and opposite account is set up that temporarily offsets the asset (receivables are debits, the allowance is a credit). If the amount due is eventually paid the allowance can be easily reduced or removed as appropriate. This course of action would be necessary if a customer was having cash flow difficulties but is still considered as being able to pay if given a little more time. Alternatively, an allowance would also be used if there was a dispute regarding the amount outstanding.

5 Accounting for irrecoverable debts

An **irrecoverable debt** is a debt which is, or is considered to be, uncollectable.

It is prudent to remove irrecoverable debts from the accounting records and to recognise the amount as an expense for irrecoverable debts in the statement of profit or loss. The original sale remains in the accounts as, at the time the sale was made, cash was expected to be received.

The double-entry required in the general ledger to achieve this is:

Dr Irrecoverable debts expense $X

Cr Trade receivables $X

The amount should also be removed from the memorandum-only account for that customer.

Test your understanding 1

Araf & Co has total accounts receivable at the end of its accounting period of $45,000. Of these items, it is discovered that one customer, MRX who owes $790, has been declared bankrupt, and another who gave the name of MJO has disappeared owing Araf & Co $1,240.

Calculate the effect in the financial statements of writing off these debts as irrecoverable.

6 Accounting for irrecoverable debts recovered

There is a possible situation whereby a debt is written off as irrecoverable in one accounting period, perhaps because the customer was in financial difficulties, and the amount due, or part it, is then unexpectedly received in a subsequent accounting period.

When the debt was written off, the double-entry in the general ledger was:

Dr Irrecoverable debts expense $X

Cr Trade receivables $X (removing the debt from the accounts)

When payment is received from a customer, the normal accounting entries are:

Dr Cash at bank $X

Cr Trade receivables $X

When an irrecoverable debt is recovered, the credit entry cannot be taken to trade receivables as the debt has already been removed from that account balance (refer back to the irrecoverable debt write-off journal above).

The **net effect** of recording two transactions above is:

Dr Cash at bank	$X
Cr Irrecoverable debts expense	$X

This serves to reverse the irrecoverable debts expense previously recorded within the statement of profit or loss.

Within a computerised system, the initial cash receipt would be processed and accounted for automatically as:

Dr Cash at bank	$X
Cr Receivables	SX

A manual journal adjustment is then be required to transfer the (unexpected) receipt of cash as a credit entry to the irrecoverable debts expense account (to reduce that expense) as follows:

Dr Receivables	$X
Cr Irrecoverable debts expense	$X

Some businesses may wish to keep a separate 'Irrecoverable debts recovered' account to determine the cost of irrecoverable debts in the period that were subsequently recovered.

Test your understanding 2

Asher had trade receivables of $3,655 at the beginning of 31 December 20X7. On that date a debt of $699 from Lex was written off. During the year to 31 December 20X8 Asher made credit sales of $17,832 and received payment from credit customers totalling $16,936. Asher also received $699 from Lex that had previously been written off in 20X7.

What is the final balance on the trade receivables account at 31 December 20X8 and 20X7?

	20X8	20X7
	$	$
A	3,852	2,956
B	3,153	2,956
C	4,551	3,655
D	3,852	3,655

7 Allowance for receivables

There may be debts included in the accounting records where there is some cause for concern but which are not yet regarded as irrecoverable.

It is prudent to recognise the possible expense of not collecting the debt in the statement of profit or loss, but the receivable must remain in the accounts in case the customer does, in fact, settle the amount outstanding.

An allowance is set up which is a credit balance. This is netted off against trade receivables in the statement of financial position to give a net figure for receivables that are regarded as probably recoverable.

The allowance should consist only of specific amounts where, for example, the customer is known to be in financial difficulty, or is disputing the invoice, or payment is already overdue, or is refusing to pay for some other reason (e.g. a faulty product), and therefore the amount owing may not be recovered. As a result, an allowance can only be established where there is objective evidence that a particular receivable may not be recovered in part or in full.

8 Accounting for the allowance for receivables

An allowance for receivables is set up with the following accounting entries:

Dr Irrecoverable debts expense $X

Cr Allowance for receivables $X

If there is already an allowance for receivables in the general ledger, only the movement in the allowance is charged to the statement of profit or loss. The movement in the allowance is calculated as the closing balance less the opening balance.

As the allowance can increase or decrease, there may be a debit or a credit in the irrecoverable debts account.

When calculating and accounting for a movement in the allowance for receivables, the following steps should be taken:

1 Write off irrecoverable debts.

2 Calculate the trade receivables balance after the write-offs.

3 Ascertain the allowance for receivables required (the year-end carry forward allowance).

4 Compare the new allowance required with the brought forward allowance.

5 Account for the change in the allowance to determine the expense or credit to the statement of profit or loss.

6 In the financial statements, deduct the closing allowance for receivables from the trade receivables balance.

Illustration 1

On 31 December 20X1 Azaria had trade receivables of $10,000. At that date, Azaria estimated that there was evidence that amounts totalling $300 may not be recovered as those receivables were already overdue. Therefore Azaria wanted to make a specific allowance for this amount.

During 20X2, Azaria made sales on credit totalling $100,000 and received payments from credit customers of $94,000. At 31 December 20X2, Azaria now considered that there was doubt regarding the recoverability of amounts totalling $700 which were overdue and which may not be recovered. The allowance for receivables should therefore be increased from $300 to $700.

During 20X3 Azaria made sales of $95,000 and collected $96,000 from credit customers. At 31 December 20X3 Azaria now considered that amounts totalling only $600 required an allowance for being overdue at that date. The allowance for receivables should therefore be adjusted from $700 to $600.

Calculate the allowance for receivables and the irrecoverable debt expense as well as the closing balance of trade receivables for each of the years ended 31 December 20X1, 20X2 and 20X3.

You should work through the information methodically, year-by-year. This will help you to understand the mechanics of how to account for trade receivables, irrecoverable debts and the allowance for receivables.

Solution to Illustration 1

Solution

20X1

Trade receivables

	$		$
At 31 December	10,000	Balance c/f (ß)	10,000
	10,000		10,000
Balance b/f	10,000		
Allowance required = $300			

Allowance for receivables

	$		$
Balance c/f	300	31 Dec	
		Irrecoverable debts	300
	300		300
		Balance b/f	300

Irrecoverable debts expense

	$		$
31 Dec		31 Dec	
Allowance for receivables	300	Profit or loss	300
	300		300

Statement of financial position presentation

	$	$
Current assets		
Trade receivables	10,000	
Less: Allowance for receivables	(300)	
		9,700

20X2

Trade receivables

	$		$
Balance b/f	10,000		
Sales	100.000	Cash at bank	94,000
		Balance c/f	16,000
	110,000		110,000
Balance b/f	16,000		
Allowance required $700			

Allowance for receivables

	$		$
		Balance b/f	
		31 Dec	300
Balance c/f	700	increase in allowance	400
	700		700
		Balance b/f	700

Irrecoverable debts expense

	$		$
31 Dec		31 Dec	
Allowance for receivables	400	Profit or loss	400
	400		400

Statement of financial position presentation

	$	$
Current assets		
Receivables	16,000	
Less: Allowance for receivables	(700)	
		15,300

20X3

Trade receivables

	$		$
Balance b/f	16,000		
Sales	95,000	Cash at bank	96,000
		Balance c/f	15,000
	111,000		111,000
Balance b/f	15,000		
Allowance required $600			

Allowance for receivables

	$		$
31 Dec		Balance b/f	700
Decrease in allowance	100		
Balance c/f	600		
	700		700
		Balance b/f	600

Irrecoverable debts expense

	$		$
31 Dec		31 Dec	
Profit or loss	100	Allowance for receivables	100
	–––––		–––––
	100		100
	–––––		–––––

Statement of financial position presentation

	$	$
Current assets		
Trade receivables	15,000	
Less: Allowance for receivables	(600)	
	–––––	14,400

Test your understanding 3

Coby Co had opening balances at 1 January 20X6 on the trade receivables account and allowance for receivables account of $68,000 and $3,400 respectively. During the year to 31 December 20X6 Coby Co made credit sales of $354,000 and collected $340,000 from credit customers.

At 31 December 20X6 Coby Co reviewed its receivables listing and acknowledged that it is unlikely to receive debts totalling $2,000. These are to be written off as irrecoverable. In addition, at that date Coby Co estimated that amounts totalling $4,000 were overdue and that an allowance for receivables was required to cover these amounts.

What is the amount charged to Coby Co's statement of profit or loss for irrecoverable debt expense in the year ended 31 December 20X6?

A $2,700

B $6,100

C $2,600

D $6,000

What will the effect be of irrecoverable debts on both the statement of profit or loss and the statement of financial position?

9 Chapter summary

Trade receivables

IRRECOVERABLE DEBTS

- Amounts that the business will not receive from its customers

ACCOUNTING FOR IRRECOVERABLE DEBTS

To recognise the expense in the statement of profit or loss

Dr Irrecoverable debts expense

Cr Receivables

ACCOUNTING FOR IRRECOVERABLE DEBTS RECOVERED

The debt has been taken out of receivables, the journal is:

Dr cash

Cr irrecoverable debts expense

ALLOWANCE FOR RECEIVABLES

- There may be some doubt as to the collectability of some of the business' receivables balances
- An allowance is made to recognise the possible expense of not receiving the cash

ACCOUNTING FOR THE ALLOWANCE FOR RECEIVABLES

To record an increase or setting up the allowance:

Dr Irrecoverable debts expense

Cr Allowance for receivables

The journal entry is reversed if the allowance is reduced

Test your understanding answers

Test your understanding 1

As the two debts are considered to be irrecoverable, they must be removed from trade receivables in the general ledger:

Trade receivables

	$		$
Balance at period end	45,000	Irrecoverable debts	
		– MRX	790
		Irrecoverable debts	
		– MJO	1,240
		Balance c/f	42,970
	45,000		45,000
Balance b/f	42,970		

Irrecoverable debts expense

	$		$
Trade receivables			
– MRX	790		
Trade receivables			
– MJO	1,240	Profit or loss	2,030
	2,030		2,030

Note that the sales revenue account has not been altered and the original sales to MRX and MJO remain. This is because these sales actually took place and it is only after the sale that the irrecoverable debt expense has occurred.

Test your understanding 2

The correct answer is A

20X7 Trade receivables

	$		$
Balance b/f	3,655	Irrecoverable debts	
		– Lex	699
		Balance c/f	2,956
	3,655		3,655
Balance b/f	2,956		

20X7 Irrecoverable debts expense

	$		$
Trade receivables			
– Lex	699	Profit or loss	699
	699		699

20X8 Trade receivables

	$		$
Balance b/f	2,956		
Sales	17,832	Cash at bank	16,936
		Balance c/f	3,852
	20,788		20,788
Balance b/f	3,852		

20X8 Irrecoverable debts expense

	$		$
Profit or loss	699	Cash at bank	699
	699		699

Test your understanding 3

The correct answer is C

Trade receivables

20X6	$	20X6	$
1 Jan Balance b/f	68,000	31 Dec Cash at bank	340,000
31 Dec Sales revenue	354,000	31 Dec Irrecoverable debts w/off	2,000
		31 Dec Balance c/f	80,000
	422,000		422,000
20X7			
1 Jan Balance b/f	80,000		

Irrecoverable debts expense

20X6	$	20X6	$
31 Dec Trade receivables	2,000		
31 Dec Increase in allowance for receivables	600	31 Dec Profit or loss	2,600
	2,600		2,600

Allowance for receivables

20X6	$	20X6	$
		1 Jan Balance b/f	3,400
31 Dec Balance c/f	4,000	31 Dec Irrecoverable debts	600
	4,000		4,000
		20X7	
		1 Jan Balance b/f	4,000

Note that only the one irrecoverable debts expense account is used to write off irrecoverable debts and also to increase or decrease the allowance for receivables. There is no need to use separate accounts for each type of expense.

Working – Allowance for receivables

\$4000 – b/f \$3,400 = increase of \$600

The **statement of financial position** will show a trade receivables balance of \$80,000. Underneath this, separately, the allowance for receivables c/f balance of \$4,000 will be deducted to give a net trade receivables total of \$76,000.

The **statement of profit or loss** will show the \$2,600 as an expense. This expense will cause a decrease in overall profits.

Chapter

11

Payables, provisions and contingent liabilities

Chapter learning objectives

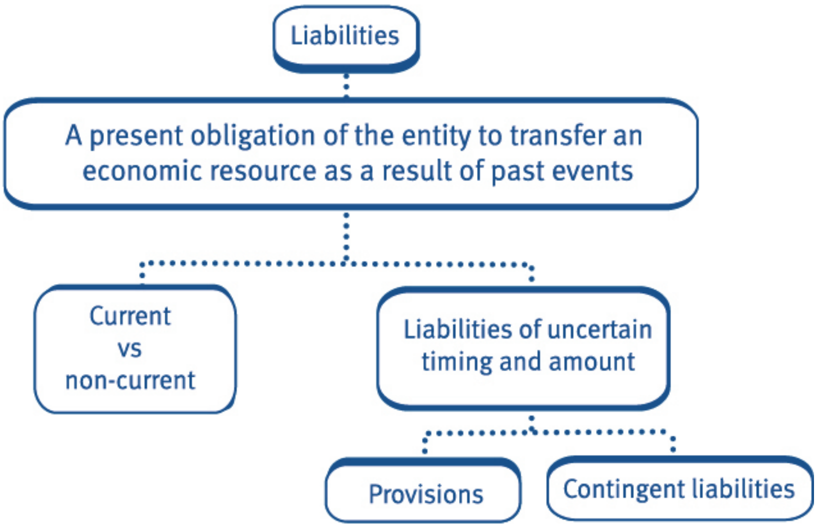
Upon completion of this chapter you will be able to:

- classify items as current or noncurrent liabilities
- identify and explain examples of payables
- define and illustrate the different accounting treatments of 'provisions,' 'contingent liabilities,' and 'contingent assets'
- calculate and record provisions and movements in provisions.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter deals with the accounting requirements for payables, provisions and contingent liabilities. In particular, it draws upon the recognition and measurement criteria contained in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. The chapter also considers classification of liabilities as either current liabilities or non-current liabilities.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies for Financial Reporting and also Strategic Business Reporting.

Examples of payables include amounts due, but not yet paid, in relation to credit purchases, sales tax and business income tax.

2 Trade payables in the general ledger

The trade payables' general ledger account may include any of the following entries:

Trade payables

Cash at bank	X	Balance b/f	X
Purchases returns	X	Credit purchases	X
Early settlement discounts received (2)	X	Interest on overdue accounts (1)	X
Contra with receivables' ledger (3)	X		
Balance c/f	X		
	X		X
		Balance b/f (4)	X

The numbered items above can be clarified as follows:

1 Suppliers may charge their customers interest on overdue amounts. If so, this will increase the amount owing to that supplier and also increase interest payable in the statement of profit and loss.

2 A credit supplier may offer a discount for early settlement of the amount due to it. If the business decides to take advantage of this opportunity, it will settle the amount due to the supplier earlier than required, leading to a reduced payment being made. The full amount due to that supplier must be removed from the trade payables account and discount received recorded in the general ledger as follows:

Debit:	Trade payables	$X
Credit:	Cash at bank	$X
Credit:	Discount received	$X

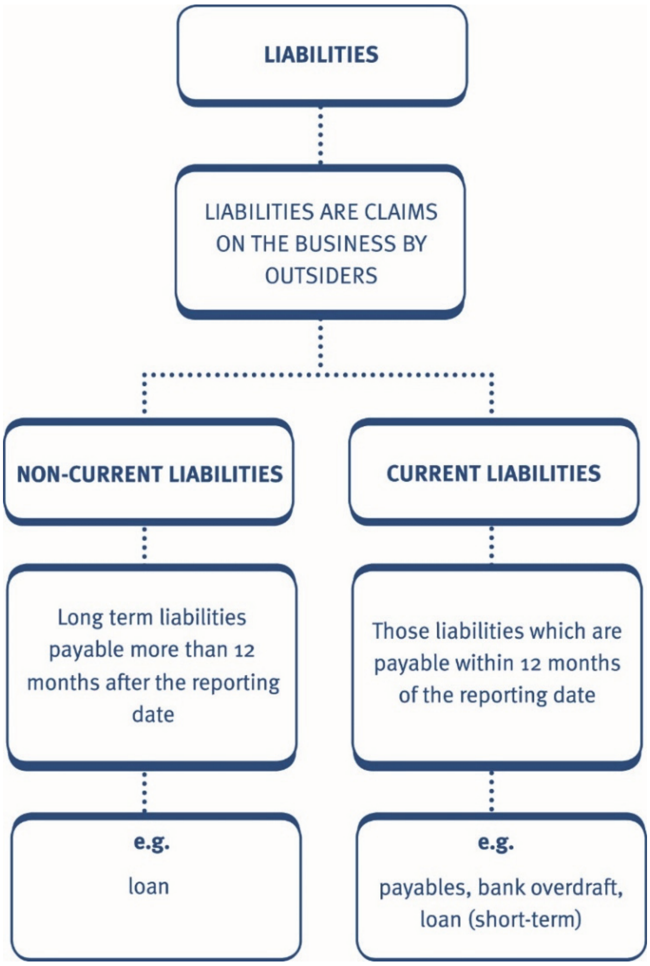
1 A business may both sell to, and buy from, another business on credit terms. If that is the case, each business will have both amounts owing both to and from each other. Rather than make payments in full to each other, the two businesses may agree to offset (or 'contra') an agreed amount against the balances due to each other. The following accounting entries will have the effect of reducing both the trade receivables' and trade payables' general ledger accounts in each business:

Debit:	Payables ledger	$X
Credit:	Receivables ledger	$X

3 The closing balance at the end of an accounting period is the balance which will be included in the statement of financial position compiled at that date. The balance will be classified as a current liability.

Remember that, as the general ledger accounts are updated, the memorandum-only individual payables ledger accounts will also be updated at the same time using the same information. Therefore, there will be no differences between the trade payables general ledger account and the total of the memorandum-only individual payables' ledger accounts.

3 Classification of liabilities



It is important to consider the timing of settlement of a liability to ensure that it is properly classified in the statement of financial position. This can be significant to many multiple choice style questions, so take care when making adjustments for liabilities. Typically trade payables (liabilities for goods and services purchased), bank overdrafts and accruals are the main forms of current liability examined in Financial Accounting. Loans (not bank overdrafts) are the principal example of non-current liabilities.

The *Conceptual Framework* defines a liability as **'a present obligation of the entity to transfer an economic resource as a result of past events'**. The obligation must be capable of being reliably measured. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* develops this principle by making reference to a legal obligation and a constructive obligation. According to IAS 37, a constructive obligation may be created by an entity having established or published policies and practices which forms a valid expectation on the part of others that it will act in a certain way.

A good example of a constructive obligation is a retail store which allows customers to return unwanted goods without being defective (for example, if the goods are of the wrong size, colour or specification) when the minimum legal obligation is to only accept goods which have been returned because they are faulty or defective in some way.

4 Cash and credit purchases

If a cash purchase is made, the business pays for the goods/services at the point of sale. Assuming that a bank payment is made (e.g. by cheque or debit card), the accounting entries for a cash purchase are:

Dr Purchases/expenses $X

Cr Cash at bank $X

If the purchase was made on credit terms the business will pay for the goods and services following delivery. Typically, trading terms allow 30 – 60 days to settle outstanding debts when purchasing goods and services on credit.

Under the accruals concept, the purchase is recorded in the general ledger accounts when the expense is incurred. That is usually the point at which the goods/services are received/rendered. Therefore, when purchases are made on credit the expense is recorded with a corresponding liability that represents the obligation to pay the supplier of the goods/services. The liability is referred to as a 'trade payable' or 'payable.'

The accounting entries are recorded as follows:

Debit: Purchases/expenses $X

Credit Trade payables $X

When the payable is subsequently settled, the accounting entries made to reflect this are:

Debit: Trade payables $X

Credit: Cash at bank $X

5 Provisions

A **provision** is defined as **'a liability of uncertain timing or amount'** (IAS 37, para 10).

For example, an entity may face a legal action for a breach of health and safety law. It may be fined if the court judgement rules against it. The timing and severity of the fine will be decided by a court at some future date.

The key questions are:

- should the entity reflect a potential liability in its financial statements?
- Should the potential consequences be disclosed to the shareholders in some way?

As owners of the business, shareholders are entitled to know about this potentially significant issue that could damage the profits and reputation of the business and, therefore, the financial value of their investment in the entity (it could even lead to the closure of the business).

Accounting for a provision

If management record to record the liability, they need to recognise a provision in the accounts. This is done by estimating the potential cost of the uncertain event and recognising it immediately. As the amount would be settled at a future date, a corresponding liability is recorded, as follows:

Debit	Expenses	$X
Credit	Provision	$X

The provision will need to be classified as either a current or non-current liability as befits the situation. The key issue is the date when the provision is likely to be settled. For example, a provision to pay compensation relating to a minor accident to an employee whilst at work should be classified as a current liability as settlement would be expected to occur within twelve months of the reporting date. A provision to dismantle and remove an item of equipment at the end of its useful life would be classified as a non-current liability if that was expected to occur more than twelve months from the reporting date.

Criteria for recognising a provision

Given the uncertainty relating to provisions there is significant scope for misstatement whether through error, or even deliberate manipulation of provisions to alter the profit disclosed in the statement of profit or loss. To reduce this risk IAS 37 specifies three criteria for recognition of a provision.

A provision shall be recognised when:

- **an entity has a present obligation (legal or constructive) as a result of a past event.**
- **it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and**
- **a reliable estimate can be made of the amount of the obligation** (IAS 37, para 14).

The criteria referred to above mean that a provision can only be recorded in an accounting period if recognition of a liability has been triggered at the year-end

Illustration 1

The criteria referred to above mean that a provision can only be recorded in an accounting period if recognition of a liability has been triggered at the year-end. For example: Smith Co's year-end is 31 December 20X7. In November 20X7, Smith Co dismissed an employee. In February 20X8, a customer slipped whilst on Smith Co's premises and broke an arm.

In March 20X8, both the employee and the injured customer sue Smith Co, the former for unfair dismissal and the latter for compensation for injuries suffered on Smith Co's premises.

Should an obligation be recognised at 31 December 20X7 for either of these lawsuits?

Solution to Illustration 1

There is a potential obligation at the year-end for the employee claiming unfair dismissal. This is because the triggering event happened in November 20X7, which is before the year-end.

There is no obligation to the injured customer at 31 December 20X7. The event happened after the year-end date of 31 December 20X7. Therefore, any financial consequences resulting from the claim made by the customer will be reflected in the financial statements for the year ended 31 December 20X8.

Obligations

Should an obligation be recognised at 31 December 20X7 for either of these lawsuits?

A legal obligation is an obligation that derives from:

- **the terms of a contract,**
- **legislation, or**
- **other operation of law** (IAS 37, para 10).

A constructive obligation is an obligation that derives from an entity's actions where:

- **by an established pattern of past practice, published policies, or a sufficiently specific current statement, the entity has indicated to other parties that it will accept certain responsibilities, and**
- **as a result, the entity has created a valid expectation on the part of those other parties that it will discharge those responsibilities** (IAS 37, para 10)

Movement in provisions

Provisions should be reviewed at each statement of financial position date and adjusted to reflect the current best estimate.

Increase in provision	Debit	Relevant expense account	$X
	Credit	Provision	$X
Decrease in provision:	Debit	Provision	$X
	Credit	Relevant expense account	$X

Illustration 2

A quarrying entity has a legal obligation to make good any environmental damage caused by its operations upon completion of its quarrying activities. The quarry is expected to be operational for eight years, commencing 1 January 20X1. At 1 January 20X1, the estimated cost of making good the environmental damage is $80,000 (ignore the effect of the time value of money).

During 20X5, the estimated cost of making good the environmental damage was reassessed to be $85,000 (ignore discounting).

(a) How would the provision be accounted for in the financial statements for the year ended 31 December 20X1?

(b) How would the movement in the provision be accounted for in the financial statements for the year ended 31 December 20X5?

Solution to Illustration 2

A provision is required as there is a constructive or legal obligation to make good any environmental damage caused during the eight years of operations, and the amount required to rectify the damage has been reliably estimated at £80,000. As there is an obligation, it is probable that there will be an outflow of economic resources to settle that obligation.

(a) There should be initial recognition of the full estimated amount of the provision of $80,000 as follows:

Debit:	Profit and loss	$80,000
Credit	Provision (non-current liability)	$80,000

(b) As the reliable estimate of the cost of making good the environmental damage has been reassessed, the movement in the provision should be reflected in the financial statements for the year ended 31 December 20X5 as follows:

Debit	Profit or loss	$5,000,
Credit: liability)		Provision (non-current $5,000

Consequently, at 31 December 20X5, the provision included in non-current liabilities is stated at $85,000.

6 Contingent liabilities and contingent assets

A contingent liability is defined as:

(a) **'a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or**

(b) **a present obligation that arises from past events but is not recognised because:**

  (i) **it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation, or**

  (ii) **the amount of the obligation cannot be measured with sufficient reliability'** (IAS 37, para 10).

When a provision is not recognised in the financial statements because it does not meet the criteria specified in IAS 37, it may still need to be disclosed as a contingent liability in the financial statements.

Examples of contingent liabilities include outstanding litigation where the potential outcome and associated costs cannot be estimated with any degree of reliability or when the likelihood of losing the litigation is only deemed possible (rather than probable).

A contingent asset is defined as **'a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity'** (IAS 37, para 10).

An example of a contingent asset is when a business claims compensation from another party and the outcome of the claim is uncertain at the reporting date.

Accounting for contingent liabilities and contingent assets

The requirements of IAS 37 regarding contingent liabilities and contingent assets are summarised in the following table:

Probability of occurrence	**Contingent liabilities**	**Contingent assets**
Probable	Recognise provision or if a reliable estimate cannot be made (which is very rare), disclose a contingent liability in the notes to the financial statements	Disclose contingent asset in note to financial statements
Possible	Disclose contingent liability in note to financial statements	Ignore
Remote	Ignore	Ignore

The basic principle is that contingent liabilities and contingent assets are not recognised in the financial statements. However, when an item is assessed as being 'virtually certain' to arise, it is no longer contingent and should be recognised as a liability or asset as appropriate.

If a contingent liability meets the three criteria for classification as a provision, it is recognised in the financial statements. If it does not meet the definition of a provision, perhaps because a reliable estimate of the obligation cannot be made, or it is assessed as 'possible' rather than 'probable' to arise, it is disclosed in the notes to the financial statements. If it is assessed as 'remote', disclosure in the financial statements is not required.

A contingent asset which is regarded as 'probable' to arise should be disclosed in a note to the financial statements. If a contingent asset is regarded as either 'possible' or 'remote' disclosure in the financial statements is not required.

The disclosure note for a contingent liability or a contingent asset should explain the nature of the item, along with an estimate of its financial effect.

Note that the reporting standard gives no guidance regarding the assessment of the probability of an event occurring, it is a matter of estimate and/or judgement. One possible interpretation is as follows:

Virtually certain > 95%

Probable 51% – 95%

Possible 5% – 50%

Remote < 5%

e.g

Illustration 3

A retail store has a policy of refunding purchases by dissatisfied customers, (e.g. when goods have been purchased and the customer decides that the goods are the wrong size, colour or style) even though it is under no legal obligation to do so. Its policy of making refunds is publicised in the store and in advertisements. The retail store has a year-end date of 31 December 20X6.

Should a provision be recognised in the financial statements for the year ended 31 December 20X6 for goods sold before the year-end which may be returned during 20X7?

Solution to Illustration 3

The policy is well known and creates a valid expectation that the store will give refunds to customers who return goods. At the year-end date, there is a constructive obligation. It is probable some refunds will be made.

The obligation can be reliably measured, perhaps by using expected values based upon past experience of what proportion or value of goods sold are actually returned by customers.

Conclusion: A provision is required and a reliable estimate of the amount should be made for inclusion in the financial statements.

Test your understanding 1

The draft financial statements of Madras Co, for the year ended 31 December 20X6 are currently under review. The following points have been raised:

(i) An ex-employee has started a legal action against Madras Co for wrongful dismissal. Madras Co's legal team have stated that the ex-employee is not likely to succeed. The following estimates have been given by the lawyers relating to the case:

(a) Legal costs (to be incurred whether the claim is successful or not) $5,000

(b) Settlement of claim if successful $15,000

Currently no provision has been made by Madras in the financial statements.

(ii) Madras Co has a policy of refunding the cost of any goods returned by dissatisfied customers, even though it is under no legal obligation to do so. This policy of making refunds is generally known. At the year end, Madras Co reliably estimated that returns totalling $4,800 will be made after the year-end.

(iii) A customer has made a claim against Madras Co for injury suffered following the purchase and use of a defective product. Legal advisers have confirmed that Madras Co will probably have to pay financial compensation of $100,000 to the customer. In turn, Madras Co has made a counter-claim against the supplier of the defective product for $100,000 and believes it is probable that its claim against the supplier will be successful.

State with reasons what adjustments, if any, should be made by Madras Co in its financial statements.

7 IAS 37 disclosure requirements

Reporting provisions in the final accounts

Provisions are reported as a liability in the statement of financial position.

Provisions may be classified as either a current or non-current liability, depending upon the subject matter of the provision.

Unless a contingent liability meets the criteria for classification as a provision, it is not recognised in the financial statements. Instead, the contingent liability will be disclosed in the notes to the financial statements.

Disclosure

The following summarises the key disclosure requirements from IAS 37 relating to provisions, contingent liabilities and contingent assets.

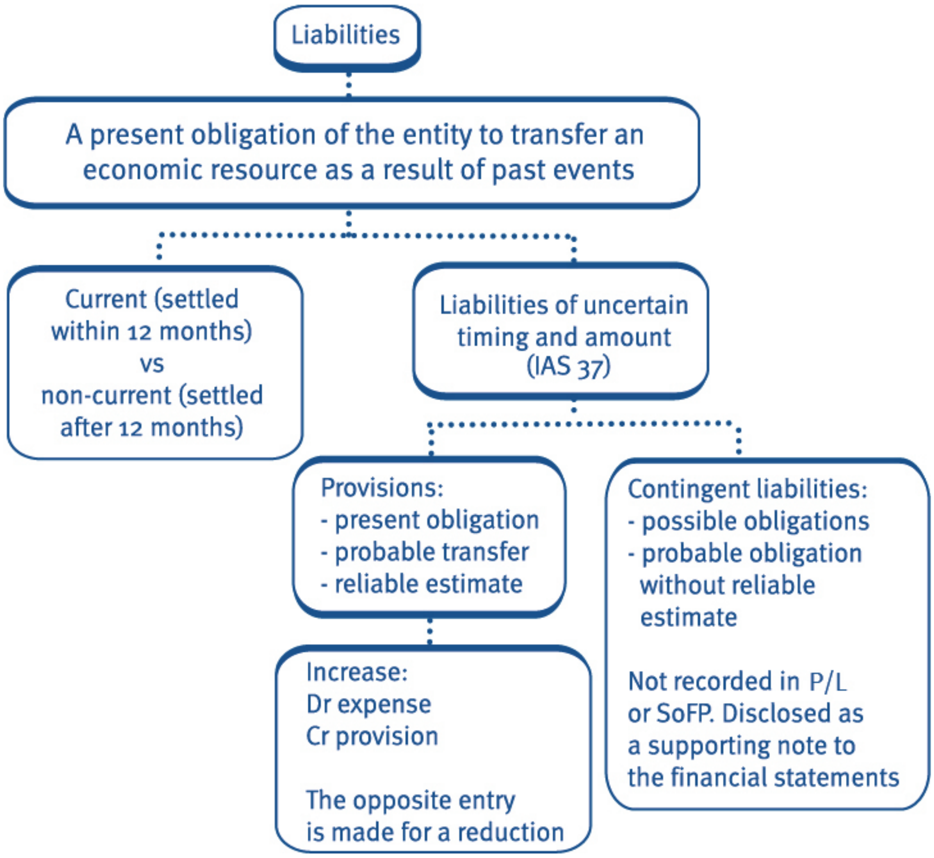
For every class of provision, the following should be disclosed:

- the carrying amount at the start and end of the accounting period
- any new provisions made in the period
- any new provisions made in the period.

For provisions, contingent liabilities and contingent assets, the following should be disclosed in a note:

- the nature of the contingency
- the uncertain factors that may affect the future outcome
- an estimate of the financial effect, or a statement that such an estimate cannot be made.

8 Chapter summary



Test your understanding answers

Test your understanding 1

(i) According to IAS 37, a provision should be recognised if: if:

(a) there is an obligation.

(b) a transfer of economic benefits is probable.

(c) a reliable estimate can be made.

The legal costs of $5,000 should therefore be provided for since they will have to be paid whatever the outcome of the legal case.

However, the claim is not likely to succeed and so no provision should be made. A disclosure note should be made for the contingent liability (i.e. potential loss if Madras Co loses the court case) of $15,000.

(ii) According to IAS 37, an obligation can be legal or constructive. In this case the policy of refunds has created a constructive obligation and it has been reliably measured. A provision for $4,800 should therefore be made in the financial statements.

(iii) As it is regarded as probable that Madras will be required to pay compensation of $100,000 to the injured customer, it constitutes a present obligation as a result of a past obligating event, and should therefore be accounted for as a provision. The success of the counterclaim for $100,000 is also considered probable and would therefore need to be disclosed in the notes to the financial statements as a contingent asset (reimbursement). Only if it were considered virtually certain would the counterclaim be recognised as an asset in the statement of financial position. Note that, even if that was the case, the provision and contingent asset would be separately accounted for in the statement of financial position – they would not be netted off.

Chapter

12

Capital structure and finance costs

Chapter learning objectives

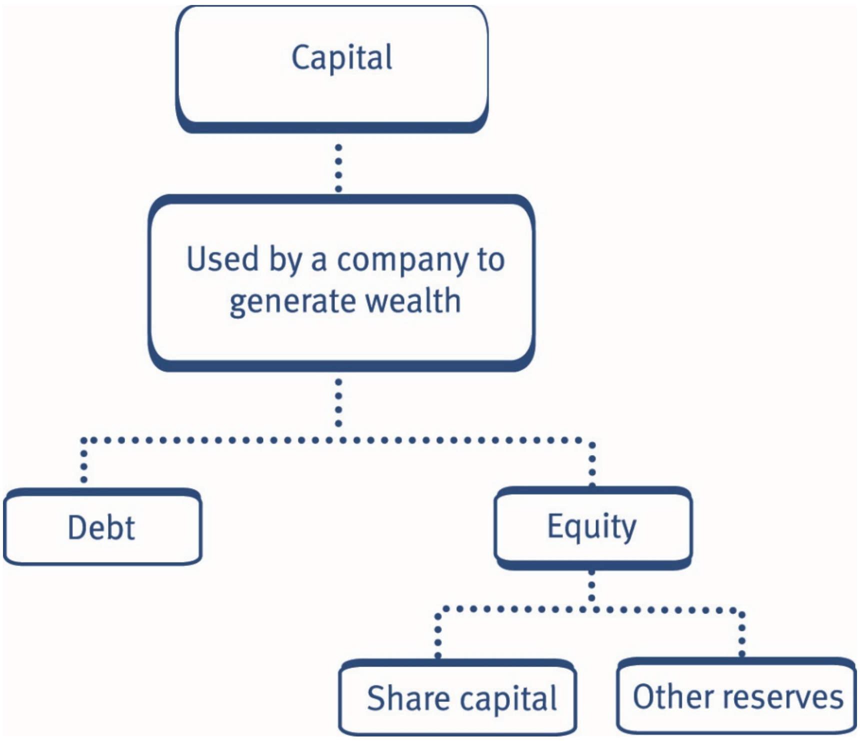
Upon completion of this chapter you will be able to:

- understand the capital structure of a limited liability company
- record movements in share capital and share premium accounts
- define, discuss and record bonus issues and rights issues
- record dividends and finance costs in the ledger accounts
- identify and record other reserves
- record income tax in the accounting ledgers.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter focusses upon the capital structure of limited liability companies. In particular, it defines and classifies debt and equity, including the different equity components.

Much of the content of this chapter is new. However, it is an important foundation for your future ACCA studies, in particular for both Financial Reporting and Strategic Business Reporting.

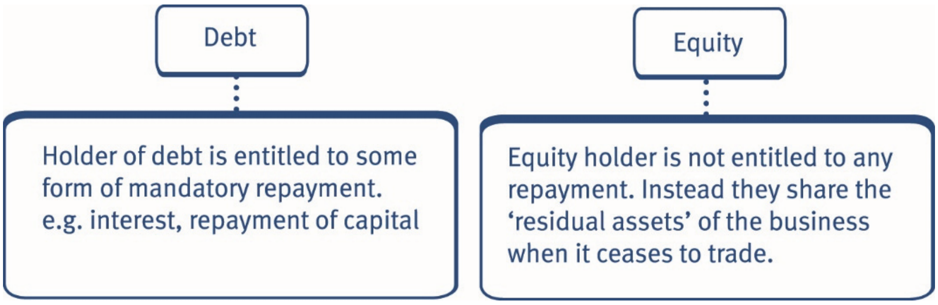
2 The capital structure of a limited liability company

All companies need to be financed, regardless of the type of company that it may be. Without financing of any sort the company would not be able to begin operating and trading; it would not be able to purchase raw materials and components, recruit staff, advertise products, or even put fuel in its vehicles.

Finance is provided by the capital invested in the company.

Capital is something that on its own has little or no use but can be employed to help generate wealth.

Money is a form of financial capital; there is not a great deal you can do with physical currency (except perhaps admire its shiny appearance or burn it if it is the paper sort) but it can be used in exchange for goods and services which can be put to good use. Most businesses will exchange money for raw materials, machinery, property, energy and labour, amongst other things. These items can then be used to create goods and services that can be sold to generate wealth for the business and its owners.



There are a number of ways that a business can attract financial capital but each has its own characteristics and consequences. In general all forms of finance can be loosely categorised into two distinct groups:

- debt, which requires some form of mandatory transfer of economic benefit (i.e. interest and capital repayment) to the provider of the finance, or
- equity, which gives the provider of the finance the rights to share in the residual assets of the business when it ceases to trade.

Most forms of finance are simple to categorise but some forms of finance have characteristics of both and it's not entirely clear whether they are debt, equity or both. For this syllabus you need to be aware of three forms of financial capital and how to record them in the financial statements:

(i) Ordinary ('equity') share capital: this is equity as the directors are under no obligation to repay the investors (shareholders) or to pay them a dividend. An ordinary shareholding is evidence of a share of ownership of a company and the shareholders receive the residual interest in the business when it ceases to trade in proportion to the size of their shareholdings. Ordinary shares are shown under equity in the statement of financial position.

Directors may choose to pay the shareholders an annual dividend. Dividends are recognised in the statement of changes in equity, **not** the statement of profit or loss. This is not a deduction from profit; it is a distribution of profit to the rightful owners of it.

(ii) Loan notes: under the terms of loan note agreements directors are usually required to pay the loan holder an annual interest payment and are obliged to repay the full debt at a later point in time. This is therefore a form of debt and appears as a liability in the statement of financial position.

The interest payment is treated as a finance charge, which is shown as an expense in the statement of profit or loss. This is a deduction from profit.

(iii) Preference shares: they can be classified as either debt or equity, depending on their terms. If there is any obligation to repay the preference shareholder (redeemable) then this is evidence of a debt. They are shown as liabilities in the statement of financial position and any dividends paid to these shareholders are treated as finance charges.

Irredeemable preference shares are shares that do not have to be repaid. They are therefore treated as equity in the statement of financial position. It must be made clear that they are not the same as ordinary shares as they do not entitle the owner to a residual interest in the business. The accompanying dividends are, however, treated the same as ordinary dividends in the financial statements.

3 Ordinary share capital

As stated above, ordinary share capital is treated as equity and the associated dividend payments are recorded in the statement of changes in equity.

Share capital terminology

Each share has a **nominal or par value,** often $1, 50c or 25c. This is an arbitrary value assigned to a share, which is often perceived as the share's minimum value. This value remains fixed, whereas the market value of the share (the value at which the share is actively traded) fluctuates over time. The par value is often used as a means of calculating dividends to shareholders (paid as a percentage of the nominal value).

Shares are sold, in the first instance, by a company at an **issue price**. This is at least equal to the nominal value of the share, but often exceeds it. After shares have been sold to the first shareholders, they may then sell their shares privately. The value at which the shares are trading on the open market is referred to as the **market value**.

The market value of a share fluctuates according to the success and perceived expectations of a company. If a company is listed on the stock exchange, the value is determined by reference to recent transactions between buyers and sellers of shares. The market value of shares do not feature in the financial statements.

Other terminology to be aware of

- **Issued** share capital is the number and nominal value of shares issued by the company to shareholders. The number of issued shares is used in the calculation of dividends.
- **Called-up** share capital is the amount of the nominal value of issued shares paid by the shareholder plus any further amounts that they have agreed to pay in the future.
- **Paid up** share capital is the amount of the nominal value which has been paid by the shareholders to the company at the current date.

Accounting for the issue of shares

When a company issues shares at their nominal value, the accounting entries required in the general ledger to record this raising of finance is:

Dr Cash at bank	$X	Issue price × no. of shares
Cr Share capital	$X	Nominal value × no. of shares

In reality companies generally issue shares at a price above their nominal value. This is referred to as issuing shares at a premium.

The double-entry to record such an issue is:

Dr Cash at bank	$X	Issue price × no. of shares
Cr Share capital	$X	Nominal value × no. of shares
Cr Share premium	$ß	(i.e. the difference between the issue price and the premium nominal value × no. of shares sold).

Both the share capital and share premium accounts are classified in the statement of financial position within the 'Equity' section.

Test your understanding 1

Bourbon Co issued 200,000 25c shares at a price of $1.75 each.

Show this transaction using ledger accounts.

4 Rights issues

A **rights issue** is:

the offer of new shares to current shareholders in proportion to their existing shareholding at a stated price (normally below market value).

The **advantages** are:

- A rights issue is the cheapest way for a company to raise finance through the issue of further shares.
- A rights issue to current shareholders has a greater chance of success compared with a share issue to the public as shares are offered at a slightly lower price as an incentive to take up the share issue.

The **disadvantages** are:

- A rights issue is more expensive than issuing debt.
- It may not be successful in raising the finance required.

A rights issue is accounted for in the same way as a normal share issue and therefore has exactly the same impact on the statement of financial position as an share issue at full price.

Test your understanding 2

Upon incorporation in 20X4, JD Co, a limited liability company, issued 1,000 50c shares at nominal value. Needing further funds, in 20X5 it made a rights issue of 1 for 5 at $0.75. This offer was fully taken up.

What accounting entries are required in 20X4 and 20X5? Illustrate the relevant section of the statement of financial position at year end 20X5.

5 Bonus issues

A **bonus issue** is:

the issue of new shares to current shareholders in proportion to their current shareholding. No cash is received by the company as a result of making a bonus issue.

The **advantages** are:

- Issued share capital is divided into a larger number of shares, thus reducing the market value per share, and so more marketable.
- Issued share capital is brought more into line with assets employed in the company by reducing stated reserves and increasing share capital.

The **disadvantages** are:

- Administration costs are incurred when making the bonus issue.

As no cash is received from a bonus issue, the issue must be funded from reserves. Any reserve can be used, though a non-distributable reserve such as the share premium account would be used in preference to reserves which can be distributed:

Dr Share premium (or other reserve)	$X Nominal value
Cr Share capital	$X Nominal value

Test your understanding 3

GKL Co currently has 20,000 50c shares in issue (each issued for $1.25) and made a 1 for 4 bonus issue, capitalising the share premium account.

What are the balances on the share capital and share premium accounts of GKL Co after this transaction?

	SC	**SP**
	$	$
A	15,000	10,000
B	12,500	12,500
C	25,000	Nil
D	22,500	2,500

Test your understanding 4

RIT Co has 200,000 25c shares in issue. At 1 January 20X6 the balance on the share premium account was $75,000. The following transactions occur during the year ended 31 December 20X6:

31 January – A ‘2-for-5’ rights issue was made which was fully taken-up by all shareholders. The issue price was $1.80.

12 August – A 1-for-10’ bonus issue was made using the share premium account.

What are the balances on the share capital and share premium accounts of RIT Co at 31 December 20X6?

	S Cap	S Prem
	$000	$000
A	308	111
B	77	84
C	154	93
D	77	192

6 Dividends

Dividends represent the distribution of profits to shareholders. They are usually expressed as an amount per share e.g. 10c per share or 10% of nominal value.

Dividends on preference shares are usually based on a pre-determined amount, such as 5% of the nominal value of the shareholding.

Dividends on ordinary shares

A company may pay a mid-year or interim dividend. The double-entry is:

Dr Retained earnings	$X (disclose in statement of changes in equity)
Cr Cash at bank	$X

At the end of the year companies may propose or declare a dividend to the ordinary shareholders (i.e. advise the shareholders the amount of a dividend to be paid after the year-end). This is a **final dividend**. These dividends must be approved by the shareholders at the annual general meeting (AGM) and until that point the company has no obligation to pay the dividend.

Therefore proposed dividends at the end of the year that have not been approved by shareholders **cannot be recorded as liabilities in the statement of financial position.**

7 Loan notes (loan stock)

A limited company can raise funds by issuing loan notes, which are fixed term loans. The term 'loan note' simply refers to the document that is evidence of the debt, often a certificate that is issued to the lender.

Similar to shares, the loan note will have a set nominal value, e.g. $100. Individuals or organisations can buy the loan notes at an agreed price (this can be any value; it does not have to be the same as the nominal value). The life of the loan note will be fixed and the company issuing them will have to pay the loan note holder back at an agreed point in time.

The issuer will also have to pay interest to the loan note holder. The interest will be calculated based on the nominal value of the loan note (for example, 5% of the nominal value per annum). The interest incurred is included in ‘finance costs’ in the statement of profit or loss.

Accounting entries

When the finance is raised and cash received the issuer of the loan note must recognise the obligation to repay the loan holder as follows:

Dr Cash at bank $X

Cr Non-current liability $X

Every year the business should recognise a finance charge (i.e. interest) based upon the terms of the agreement as follows:

Dr Finance charges (P/L) $X

Cr Cash at bank/current liabilities $X

(depending on whether the interest has been paid or not).

Note that this is a simplistic approach to accounting for loan notes. This approach will be developed more in your subsequent ACCA studies which considers the accounting requirements of IFRS 9 Financial instruments.

Test your understanding 5

Custard Creameries Co needs to raise funds to purchase plant and machinery. On 1 March 20X5 it issued $150,000 10% loan notes, redeemable in 10 years’ time. Interest is payable half yearly at the end of August and February.

What accounting entries are required in the year ended 31 December 20X5? Show relevant extracts from the statement of financial position.

8 Preference shares

If preference shares are redeemable they are treated in the same way as loan notes; i.e. they are recorded as a liability in the statement of financial position and dividend payments are treated the same as finance charges.

If the preference shares are irredeemable the shareholding and associated dividends are treated exactly the same as ordinary shareholdings, as explained above.

Test your understanding 6

Cracker Co, a limited liability entity, had issued share capital throughout 20X7 as follows:

Ordinary share capital (50c shares) $200,000

8% Irredeemable preference share capital $50,000

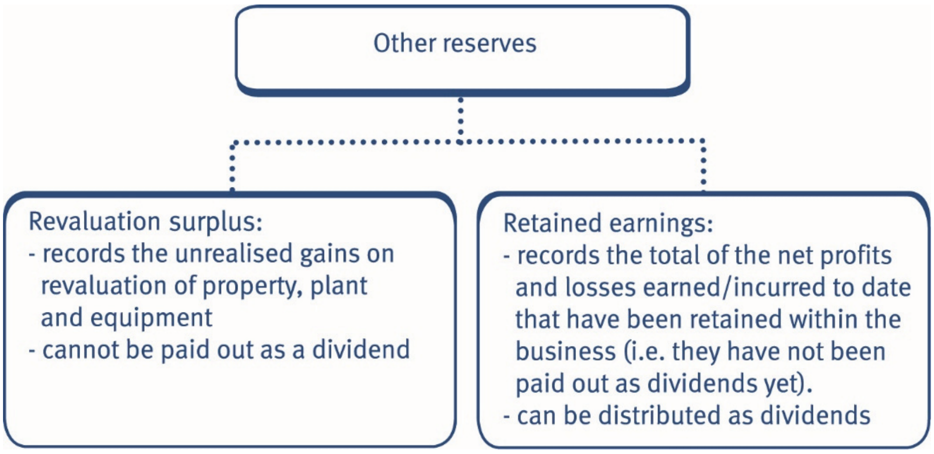
Cracker Co paid an interim dividend (i.e. a dividend declared part way through the financial year) of 12.5c per share to its ordinary shareholders and paid the dividend due on the preference shares, although this is not mandatory. Prior to the year-end Cracker Co proposed a final dividend of 36.5c per share to its ordinary shareholders.

Calculate the amounts shown in the statement of changes in equity (SOCIE) and statement of financial position (SFP) in relation to dividends for the year ended 31 December 20X7.

	SOCIE	**SFP**
	$000	$000
A	200	150
B	54	nil
C	200	146
D	101	72

9 Other reserves

In addition to using loan capital and share capital, companies also use the capital created internally to generate wealth by reinvesting accumulated profits (also referred to as retained earnings) back into the business. These capital sources represent the profits made by the business and the increase in value of tangible non-current assets which have been accounted for and recognised in a revaluation surplus account. They are referred to as other components of equity (or reserves).



A specimen statement summarising changes in equity during the year is presented below:

Statement of changes in equity for the year ended 30 June 20X7

	Equity share capital	**Share premium**	**Revaluation surplus**	**Retained earnings**	**Total**
	$	$	$	$	$
Balance at 1 July 20X6	34,000	1,100	3,000	25,200	63,300
Profit after tax for the year				19,950	19,950
Dividend paid in the year				(1,500)	(1,500)
Revaluation in the year			2,000		2,000
Issue of share capital	6,000	900			6,900
Balance at 30 June 20X7	40,000	2,000	5,000	43,650	90,650

The opening balances in the statement should correspond with the balances in the statement of financial position for the previous year i.e. 30 June 20X6 in the specimen SICIE above. The closing balances are included in the statement of financial position as at that date.

Retained earnings

Retained profits are due (although generally not paid out) to the ordinary shareholders of the company. As they are the owners of the company the profits made by that company are their property. It therefore follows that they should be presented as part of the company's liability to the shareholders.

10 Income tax

In the same way that individuals are subject to tax on their income, the income generated by a business entity is also subject to tax.

Sole traders and partnerships

In the case of a sole trader or a partnership, the tax charge is imposed upon the individual, rather than the business. Consequently, if the business Cash at bank account is used to pay what is a personal tax liability, it will be accounted for as a form of drawings made from the business by the owner.

Limited liability companies

In the case of a limited liability company, as it is a separate legal entity, if it generates income, it will be subject to tax. Consequently, the tax charge tax must be reflected in the statement of profit or loss as an expense and any tax liabilities outstanding must be reflected in the statement of financial position.

This is normally referred to as **'income tax'** as it is a tax charge on the income of a company. In the UK, this was traditionally referred to as corporation tax, but is now more commonly referred to as income tax. It should not be confused with the income tax paid by individual employees on their salary and other earnings.

The charge for income tax is based upon the level of profits earned by the company and the tax rates in place at the time of calculation.

Company year-ends and tax year-ends rarely match. Therefore companies must estimate their income tax liability at the end of each accounting period and record an appropriate estimate of the liability likely to be paid.

These estimates are unlikely to be entirely accurate (they are usually a 'best estimate' when the financial statements are being prepared) and, as such, companies tend to either over or under estimate the provision for income tax, which is adjusted for in the following year's financial statements.

You will not be required to have any tax-related knowledge to calculate tax charges. For the purposes of Financial Accounting, you are required to understand how income tax charges and liabilities are accounted for in the financial statements of a limited company. In many ways, it is similar to accounting for a provision – recognise a liability when required, with any movement in the liability accounted for in the statement of profit or loss.

Steps for recording income tax

Step 1

At the end of the year a company should make the following double-entry for its estimate of the tax liability:

Dr Income tax charges (P&L) $X

Cr Income tax liability (SFP) $X (a current liability)

Step 2

Following the year-end the actual tax liability will be determined and paid. The associated double-entry is:

Dr Income tax liability	$X
Cr Cash at bank	$X

Step 3

It is unlikely that the actual charge will match the estimated liability so the tax liability account will be left with a closing balance carried forward. This needs to be removed as the liability has been settled (i.e. there should not be any carried forward balances because the tax authorities have been paid the correct amount).

If there is an overprovision in the prior year (i.e. estimate was greater than the amount paid) there will be a closing credit balance carried forward.

This is adjusted as follows:

Dr Income tax liability	$X
Cr Income tax charge.	$X

As the company made an overestimate of the liability, the charge for the following year is reduced by the appropriate amount so that, over the two-year period, the correct charge has been recorded.

If there is an underestimate in the prior year (i.e. estimate was less than the amount paid) there will be a closing debit balance carried forward. This is adjusted as follows:

Dr Income tax charge	$X
Cr Income tax liability	$X

As the company made an underestimate of the liability, the charge for the following year is increased by the appropriate amount, so that over the two-year period, the correct charge has been recorded.

Accounting entries – Further explanation

In simple terms, **the income tax liability in the statement of financial position should only ever be equal to the estimate of the tax liability at the end of the year.** (The under/over provision from the prior year should have been sorted corrected before the year-end).

The charge to the statement of profit or loss can be calculated as follows:

	$000
Current tax estimate	X
Under/(over) provision in prior year	X/(X)
Total income tax charge for the year	X

Test your understanding 7

GB Co commenced trade on 1 January 20X4 and estimated that the tax payable for the year ended 31 December 20X4 was $150,000.

In September 20X5, the accountant of GB Co received and paid a tax demand for $163,000 for the year ended 31 December 20X4. At 31 December 20X5 it was estimated that GB Co owed $165,000 for income tax in relation to the year ended 31 December 20X5.

Prepare the tax charge and income tax payable accounts for the years ended 31 December 20X4 and 20X5 and detail the amounts shown in the statement of financial position and statement of profit or loss in both years.

Test your understanding 8

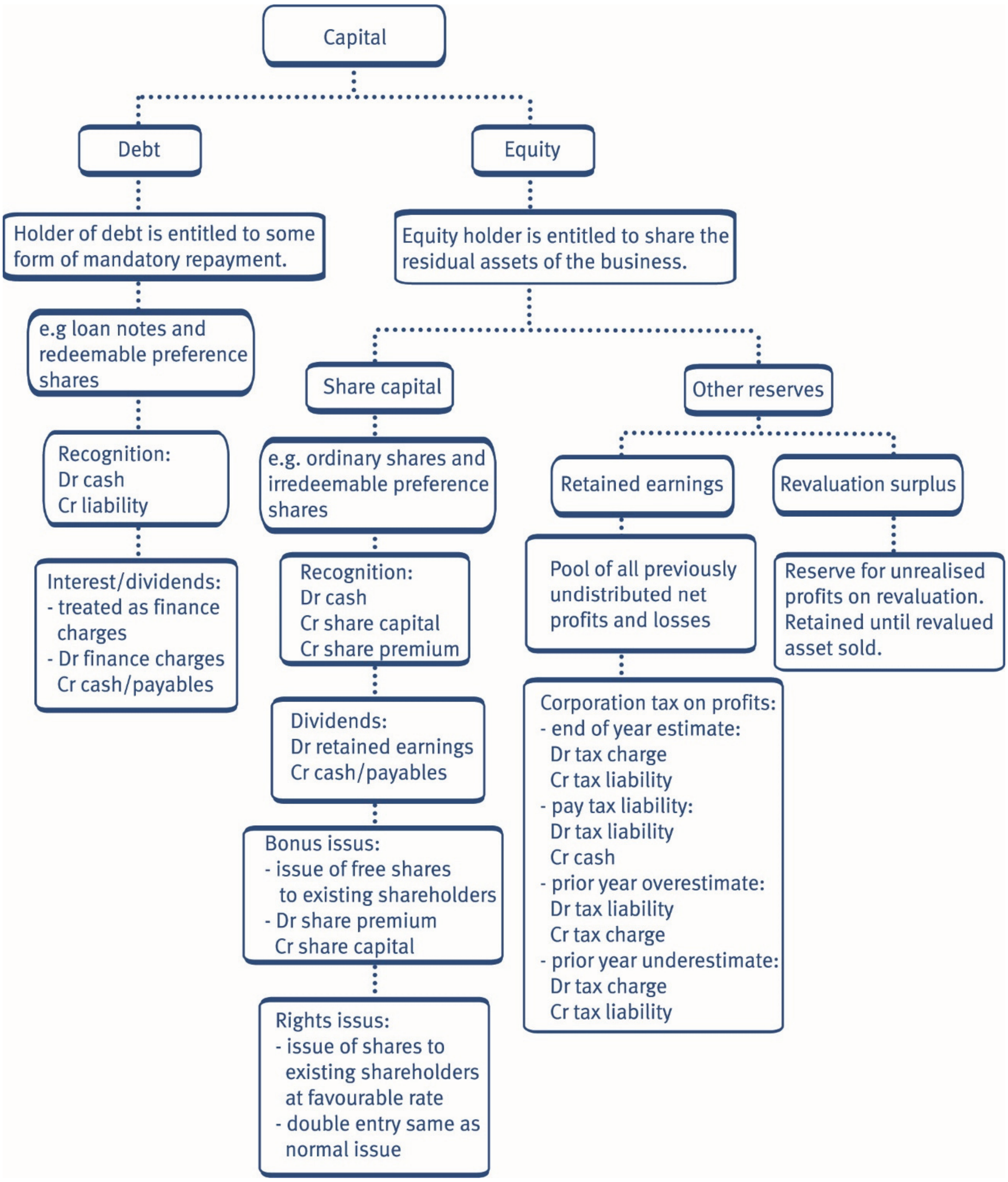
Choc Co estimated the tax charge for the year ended 30 June 20X4 to be $230,000. Choc Co settled the amount due with the tax authorities at $222,000. The difference arose because Choc Co's financial statements were submitted before the tax computation was finalised. Therefore the directors had to make a prudent estimate of the potential income tax liability to include in the financial statements.

For the year ended 30 June 20X5, Choc Co estimated its tax bill to be $265,000, but it is a little confused as to how this should be reflected in the financial statements.

Which of the following is correct relating to taxation in Choc Co's financial statements for the year ended 30 June 20X5?

	Statement of financial position liability	**Tax expense**
	($)	($)
A	257,000	265,000
B	273,000	265,000
C	265,000	257,000
D	265,000	273,000

11 Chapter summary



Test your understanding answers

Test your understanding 1

Cash at bank

	$		$
Share capital/share premium	350,000		

Share capital

	$		$
		Cash at bank	50,000

Share premium

	$		$
		Cash at bank	300,000

Working

Nominal value: 200,000 × $0.25 = $50,000

Funds raised: 200,000 × $1.75 = $350,000

Test your understanding 2

20X4	Dr Cash at bank	$500
	Cr Share capital	$500

20X5 For every five shares a shareholder owns, the shareholder is entitled to buy another one. The offer is fully taken up, meaning that 200 new shares are issued (1,000 shares/5 × 1).

Dr Cash at bank (200 × $0.75)	$150
Cr Share capital (200 × $0.50)	$100
Cr Share premium	$50

Statement of financial position

Equity:

	$
Share capital – 50c ordinary shares	600
Share premium	50
Accumulated profit	X

Test your understanding 3

The correct answer is B

- For every four shares held, a new share is issued.
- Therefore 5,000 new shares are issued (20,000 shares/4 × 1)

Dr Share premium (5,000 × 50c)	$2,500
Cr Share capital	$2,500

Statement of financial position – Equity

	$
Share capital – 50c ordinary shares (20,000 × $0.5) + $2,500	12,500
Share premium (20,000 × ($1.25 – $0.5)) – $2,500	12,500
Accumulated profit	X

Test your understanding 4

The correct answer is D

Share capital

	$		$
		Balance b/f	50,000
		Cash at bank (Rights issue)	20,000
Balance c/f	77,000	Share premium (Bonus issue)	7,000
	77,000		77,000
		Balance b/f	77,000

Share premium

	$		$
		Balance b/f	75,000
Bonus issue (S Cap)	7,000	Cash at bank (Rights issue)	124,000
Balance c/f	192,000		
	199,000		199,000
		Balance b/f	192,000

Statement of financial position – Equity

	$
Share capital – 25c ordinary shares	77,000
Share premium	192,000
Retained earnings	X

Working

Rights issue: (200,000/5) × 2 = 80,000 new shares

Proceeds: 80,000 × $1.80 = $144,000

Nominal value: 80,000 × 25c = $20,000

Bonus issue: (280,000/10) × 1 = 28,000 new shares

Nominal value: 28,000 × 25c = $7,000

Test your understanding 5

1 March 20X5 Dr Cash at bank	$150,000
Cr 10% Loan notes	$150,000
31 August 20X5 Dr Finance cost	$7,500
Cr Cash at bank	$7,500
$150,000 × 10% × 6/12 = $7,500	
31 December 20X5 Dr Finance cost	$5,000
Cr Interest accrual	$5,000
$150,000 × 10% × 4/12 = $5,000	

Statement of financial position

Non-current liabilities	$
10% Loan notes	150,000
Current liabilities	
Trade payables	X
Loan note interest payable	5,000

Test your understanding 6

The correct answer is B

No. of issued ordinary shares = $200,000/50c = 400,000

Interim ordinary dividend:

400,000 × 12.5c = $50,000

Preference dividend:

50,000 × 8% = $4,000

Statement of changes in equity

	$
Retained earnings at start of year	X
dividends ($50,000 + $4,000)	(54,000)
At end of year	X

Note: The proposed final dividend cannot be accounted for until approved at the AGM and therefore cannot be a liability at the year-end.

Test your understanding 7

Tax payable (statement of financial position)

	$		$
20X4		20X4	
Balance c/f	150,000	Profit or loss	150,000
	150,000		150,000
Sept X5 Cash at bank	163,000	20X5 Balance b/f	150,000
		Under-provision b/f	13,000
Balance c/f	165,000	20X5 Profit or loss	165,000
	328,000		328,000
		20X6 Balance b/f	165,000

Tax charge (statement of profit or loss)

	$		$
20X4 tax payable	150,000	Profit or loss	150,000
	150,000		150,000
20X5 Under-provision	13,000		
Tax payable	165,000	Profit or loss	178,000
	178,000		178,000

The tax charge in 20X5 is increased to reflect the under-provision made in 20X4.

Statement of financial position

	20X5	**20X4**
	$000	$000
Income tax liability	165	150
Statement of profit or loss		
Tax expense	178	150

Test your understanding 8

The correct answer is C

- The liability in the statement of financial position = the estimated amount payable for the year ended 30 June 20X5.
- The tax charge in the statement of profit or loss = the estimated amount payable for the year ended 30 June 20X5, less the overprovision relating to the previous year.

Chapter

13

Reconciliations

Chapter learning objectives

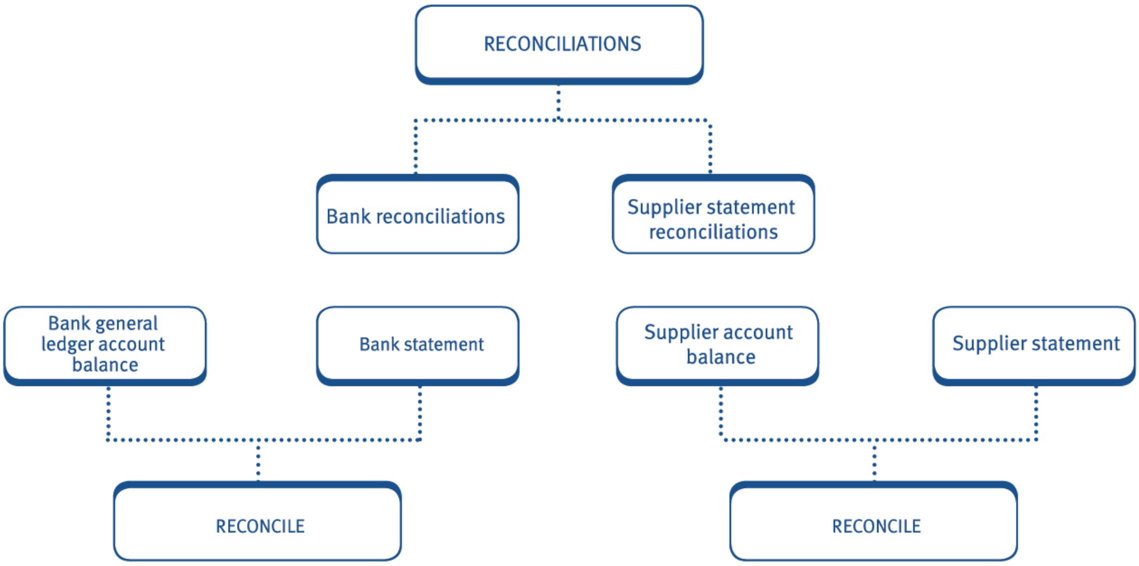
Upon completion of this chapter you will be able to:

- understand and explain the purpose of bank reconciliations
- identify the main reasons for differences between the cash at bank general ledger account and the bank statement
- identify and correct errors and/or omissions in the cash at bank general ledger account
- prepare bank reconciliation statements
- derive bank statement and cash at bank general ledger account balances from given information
- identify the cash at bank general ledger account balance to be reported in the financial statements
- understand and explain the purpose of reconciling the balances on individual supplier accounts to external documents
- prepare a reconciliation of the balances on individual supplier accounts to supplier statements
- identify and correct errors which would be highlighted by performing a reconciliation of the supplier accounts.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter deals with the reasons for preparing a bank reconciliation, and how the reconciliation is prepared. In particular, it deals with and explains the sources of difference at a particular point between the bank statement and the cash at bank general ledger account of an entity.

This chapter also deals with the reasons for preparing reconciliations of supplier statements with individual supplier account balances, identifying any differences between the two documents and resolving issues arising.

Much of the content of this chapter is likely to be new to you. However, it is an important foundation for your future ACCA studies, in particular for Financial Reporting. Such reconciliations are regularly used within accounts departments for all types of business. If you work in a finance department in industry or for an accounting firm in practice (particularly if involved with audit or accounts preparation), it is highly likely you will encounter bank and supplier statement reconciliations as part of your professional role.

2 The bank reconciliation

The objective of a bank reconciliation is to reconcile the difference between:

- the cash at bank general ledger account balance, i.e. the entity's record of its bank account, and
- the bank statement balance, i.e. the bank's record of the bank account.

The cash at bank general ledger account contains the entity's record of the transactions which have passed through the bank account.

Note that debits and credits are reversed on bank statements because the bank will record transactions from its own perspective in accordance with the business entity concept. As such, if an account-holder has cash in the bank, from the perspective of the bank, that account balance is a liability that must be repaid to the account-holder. Therefore, to record a payment made by the entity, a credit entry is made in the cash at bank general ledger account, but this will be reflected on the bank statement as a debit entry.

Reasons to prepare a bank reconciliation statement

Nature and purpose of a bank reconciliation statement

The contents of the cash at bank general ledger account should be exactly the same as the record provided by the bank in the form of a bank statement, and therefore the entity's records should correspond with the bank statement.

This theory is accurate, but with three important provisos:

1 The ledger account maintained by the bank is the opposite way around to the cash at bank general ledger account maintained by the entity. This is because the bank will record transactions and balances from its own perspective. Therefore, if a client has a positive bank balance the bank would display this as a credit balance because it has a liability to repay the amount to the client. If the client is overdrawn this would be shown as a debit because the bank is owed a repayment by the client.

2 Timing differences must inevitably occur. A cheque payment is recorded in the cash at bank general ledger account when the cheque is despatched. The bank only records such a cheque when it is paid and cleared by the bank, which may be several days later.

3 Items such as interest may appear on the bank statement but are not recorded in the cash at bank general ledger account as the entity is not yet aware that the transaction has occurred.

The existence of the bank statement provides an important check on the most vulnerable of an entity's assets – cash. However, the differences referred to above make it essential to reconcile the balance on the cash at bank general ledger account with that of the bank statement.

The reconciliation is carried out frequently, usually at monthly intervals.

3 Differences between the bank statement and the ledger account

When attempting to reconcile the cash at bank general ledger account with the bank statement, there are three key differences between the two records:

- unrecorded items
- timing differences
- errors.

Ledger account adjustments

Unrecorded items

These are items which are recorded in the bank statements before they are recorded in the cash at bank general ledger account. Such 'unrecorded items' may include:

- interest received or paid
- bank charges
- dishonoured cheques.

Unrecorded items are not recorded in the general ledger account simply because the entity does not yet know that these items have arisen until it receives and reviews the bank statement.

The cash at bank general ledger account must be updated to reflect these items.

Test your understanding 1

On which side of the cash at bank general ledger account should the following unrecorded items be posted?

- bank charges
- direct debits/standing orders
- direct credits
- dishonoured cheques received from customers
- bank interest received.

Bank statement adjustments

Timing differences

These items have been recorded in the cash at bank general ledger account, but due to the bank clearing process have not yet been included in the bank statement:

- Outstanding/unpresented cheques (cheques sent to suppliers but not yet cleared by the bank).
- Outstanding/uncleared lodgements (cheques received by the entity but not yet cleared by the bank).

The bank statement balance needs to be adjusted for these items:

	$
Balance per bank statement	X
Less: Outstanding/unpresented cheques	(X)
Add: Outstanding/uncleared lodgements	X
Balance per cash at bank general ledger account (revised)	X

Errors in the cash at bank general ledger account

The business may make a mistake in its general ledger accounting entries. The cash at bank general ledger account will need to be adjusted for any items which affect that account.

Errors in the bank statement

The bank may make a mistake, e.g. record a transaction relating to a different account-holder in an entity's bank statement, or record the wrong amount. The bank statement balance will need to be adjusted for such items and the bank advised accordingly.

Outstanding payments and receipts

Outstanding or unpresented cheques

Suppose a cheque relating to a payment to a supplier of Poorboy is written, signed and mailed to the supplier on 29 March. It is also entered in the cash at bank general ledger account on the same day. By the time the supplier has received the cheque and paid it into its bank account, along with the time it takes for the cheque to be processed through the bank clearing system, it may not appear on Poorboy's statement until, say, 6 April. Poorboy would regard the payment as being made on 29 March and its cash at bank general ledger account balance as reflecting the true position at that date.

Outstanding deposits/lodgements

In a similar way, an entity may receive cheques by post on 31 March, enter the receipts into the general ledger and deposit them into the bank on the same day. Nevertheless, the cheques may not appear on the bank statement until, say, 2 April. Again, the cash at bank general ledger account is regarded as showing the true position. Outstanding deposits are also known as outstanding lodgements.

4 Pro-forma bank reconciliation

Cash at bank ledger account

Bal b/f (Note 1)	X	Bal b/f (Note 1)	X
Adjustments	X	Adjustments	X
Revised bal c/f	X	Revised bal c/f	X
	X		X
Revised bal b/f (Note 1)	X	Revised bal b/f (Note 1)	X

Bank reconciliation statement as at...

	$
Balance per bank statement	X
Outstanding cheques	(X)
Outstanding lodgements	X
Other adjustments to the bank statement	X(X)
Balance per cash at bank ledger account (revised)	X

Note 1 – the cash at bank general ledger account balance at the start of an accounting period may be either a debit balance (cash in the bank) or a credit balance (overdrawn). Similarly, the cash at bank general ledger account balance at the end of the accounting period (or the date at which the bank reconciliation is performed) could be either a debit balance or a credit balance.

Points to be alert to:

- beware of overdrawn balances on the bank statement – ensure that your arithmetic is correct when dealing with adjustments
- beware of debits/credits to bank statements – they are the opposite way to the cash at bank general ledger account entries
- beware of aggregation of deposits on a bank statement entry.
- **Note that the bank balance on the statement of financial position is always the balance per the revised cash at bank general ledger account.**

Test your understanding 2

In preparing an entity's bank reconciliation statement, the accountant finds that the following items have caused a difference between the cash at bank ledger account balance and bank statement balance:

1 Direct debit $530.

2 Lodgements not credited $1,200.

3 Cheque paid in by the entity and dishonoured $234.

4 Outstanding cheques $677.

5 Bank charges $100.

6 Error by bank $2,399 (cheque incorrectly credited to the account).

Which of these items will require an entry in the cash at bank ledger account?

A 3, 4 and 6

B 1, 3 and 5

C 1, 2 and 4

D 2, 5 and 6

Test your understanding 3

The following information has been extracted from the records of N Patel:

Cash at bank ledger account

		$			Chq no	$
1 Dec	Balance b/f	16,491	1 Dec	Alexander	782	857
2 Dec	Able	962	6 Dec	Burgess	783	221
	Baker	1,103	14 Dec	Barry	784	511
10 Dec	Charlie	2,312	17 Dec	Cook	785	97
14 Dec	Delta	419	24 Dec	Hay	786	343
21 Dec	Echo	327	29 Dec	Rent	787	260
23 Dec	Cash sales	529				
30 Dec	Fred	119	31 Dec	Balance c/f		19,973
		22,262				22,262

High Street Bank

Bank Statement – N. Patel

Date	**Details**	**Withdrawals**	**Deposits**	**Balance**
		$	$	$
1 December	Balance b/f			17,478
2 December	780	426		
2 December	781	737		16,315
2 December	Deposit		176	16,491
5 December	782	857		
5 December	Bank charges	47		15,587
6 December	Deposit		2,065	17,652
10 December	Standing order (rates)	137		17,515
11 December	783	212		17,303
13 December	Deposit		2,312	19,615
17 December	784	511		19,104
17 December	Deposit		419	19,523
23 December	Deposit		327	19,850
24 December	Deposit		528	20,378
28 December	786	343		20,035
30 December	310923	297		19,738
31 December	Balance c/f			19,738

(a) **Prepare a bank reconciliation statement at 1 December.**

(b) **Update the cash at bank ledger account for December.**

(c) **Prepare a bank reconciliation statement at 31 December.**

Test your understanding 4

The following is a summary of Adin's cash at bank ledger account as presented to you for the month of December 20X6:

Cash at bank ledger account

	$		$
Receipts	1,469	Balance b/f	761
Balance c/f	554	Payments	1,262
	2,023		2,023

All receipts are banked and all payments are made by cheque.

Upon investigation you discover:

1 Bank charges of $136 entered on the bank statement had not been entered in the cash at bank ledger account.

2 Cheques drawn amounting to $267 had not been presented to the bank for payment.

3 The accounting entries for a cheque payment of $22 had been reversed and accounted for as a receipt in the cash at bank ledger account instead of as a payment;

4 A cheque drawn for $6 had been incorrectly entered in the cash at bank ledger account as $66.

What balance is shown on the bank statement at 31 December 20X6?

A $913

B $941 overdraft

C $941

D $407 overdraft

5 Supplier statement reconciliations

Initially when a purchase invoice is received from a credit supplier, the normal accounting entries are:

Debit: Purchases	\$X
Credit: Payables	\$X

When payment is subsequently made, the accounting entries in the general ledger are:

Debit: Payables	\$X
Credit: Cash at bank	\$X

Remember that there will also be simultaneous update of the memorandum individual payable ledger account when these transactions are processed in the general ledger.

It would be expected that the total of the payables' general ledger account should equal the total of the individual payables' ledger account balances. However, such agreement cannot reveal whether all transactions with each individual supplier have been correctly recorded in the general ledger. For instance, transactions may be omitted or incorrectly entered into either or both records.

Many suppliers issue a monthly statement to their customers detailing the movements on the customer's account stating the amount outstanding at the statement date. In effect, this is the supplier's memorandum receivable ledger account which should match the payable ledger account of the customer. Therefore, it is possible to use this statement (referred to as a supplier's statement) to check whether all transactions have been correctly included in the general ledger.

Ideally, an individual payables' ledger account should be a mirror image of the supplier statement covering the same period – the balance shown as due in the supplier statement should be the same as that showing as due to the supplier per the entity's individual payables' ledger account.

However, differences between the supplier statement and the individual supplier ledger account do arise for a number of reasons. Examples include:

- payment made to the supplier but not yet recorded in the supplier statement
- invoice from the supplier not yet recorded in the general ledger and individual ledger account of the supplier
- discount received and recorded in the general ledger but not yet recorded in the supplier statement, or vice versa
- goods returned to the supplier for a refund or credit note but not yet included in the supplier statement

- differences in monetary amounts recorded in the payables' ledger account when compared with the supplier statement e.g. invoice amount per statement is, say, $345.00 and the amount recorded in the general ledger and individual payable's ledger account is $435.00.

If, following investigation an amendment is required, remember that any amendment required to an individual ledger account balance will also require amendment in the payables general ledger account. Any amendment required would be processed by use of a journal adjustment. If the error is in the supplier statement, the supplier should be advised so that it can be rectified.

e.g

Illustration 1

Below is an example extract of a statement from LNP Co, a supplier received by Trio Co:

STATEMENT					
Date	**Transaction**	**Total** $	**Current** $	**30+** $	**60+** $
10 May 20X9	Invoice 100	94.50			94.50
1 June 20X9	CN 2008	(24.56)			(24.56)
4 July 20X9	Invoice 110	101.99		101.99	
15 July 20X9	Invoice 156	106.72	106.72		
	TOTALS	278.65	106.72	101.99	69.94
You are reminded that our credit terms are 30 days.					

Here is Trio Co's payable account for LNP Co:

LNP Co

	$			$
01 Jun 20X9 CN	24.56	10 May 20X9	Invoice 100	94.50
		04 Jul 20X9	Invoice 110	110.99
Balance c/f	287.65	15 Jul 20X9	Invoice 156	106.72
	312.21			312.21
		Balance b/f		287.65

The balance on the supplier statement of $278.65 from LNP Co does not agree with the balance on Trio Co's payable ledger account for LNP Co. Reviewing each transaction in turn, it can be seen that that the invoice dated 4 July 20X9 in the ledger is for a total $110.99, however in the statement it appears as $101.99. The purchase invoice itself should be reviewed to check which amount is correct. If the supplier statement is incorrect, the supplier should be informed who should then update its accounting records.

If it is the ledger that is incorrect then Trio Co's general ledger should be corrected by a journal adjustment which will include simultaneous update of the individual payable ledger account.

Test your understanding 5

BDC Co received the following statement of account from its supplier SWY Co:

SWY Co – STATEMENT OF ACCOUNT

Customer BDC Co

Date	**Transaction**	**Total** $	**Current** $	**30+** $	**60+** $
1 May 20X2	Invoice 321	374.50			374.50
21 Jun 20X2	Invoice 334	104.56			104.56
4 July 20X2	CN 2008	(65.00)		(65.00)	
29 July 20X2	Invoice 369	206.72	206.72		
	TOTALS	620.78	206.72	(65.00)	479.06

Credit terms: 30 days.

BDC Co's payable account for SWY Co was a follows:

SWY Co

	$			$
04 Jul 20X2 CN	65.00	01 May 20X2	Invoice 321	374.50
		21 Jun 20X2	Invoice 334	104.56
Balance c/f	414.06			
	479.06			479.06
		Balance b/f		414.06

What could be a possible reason for the difference between the two documents?

A There is an arithmetic error in the statement prepared by SWY Co

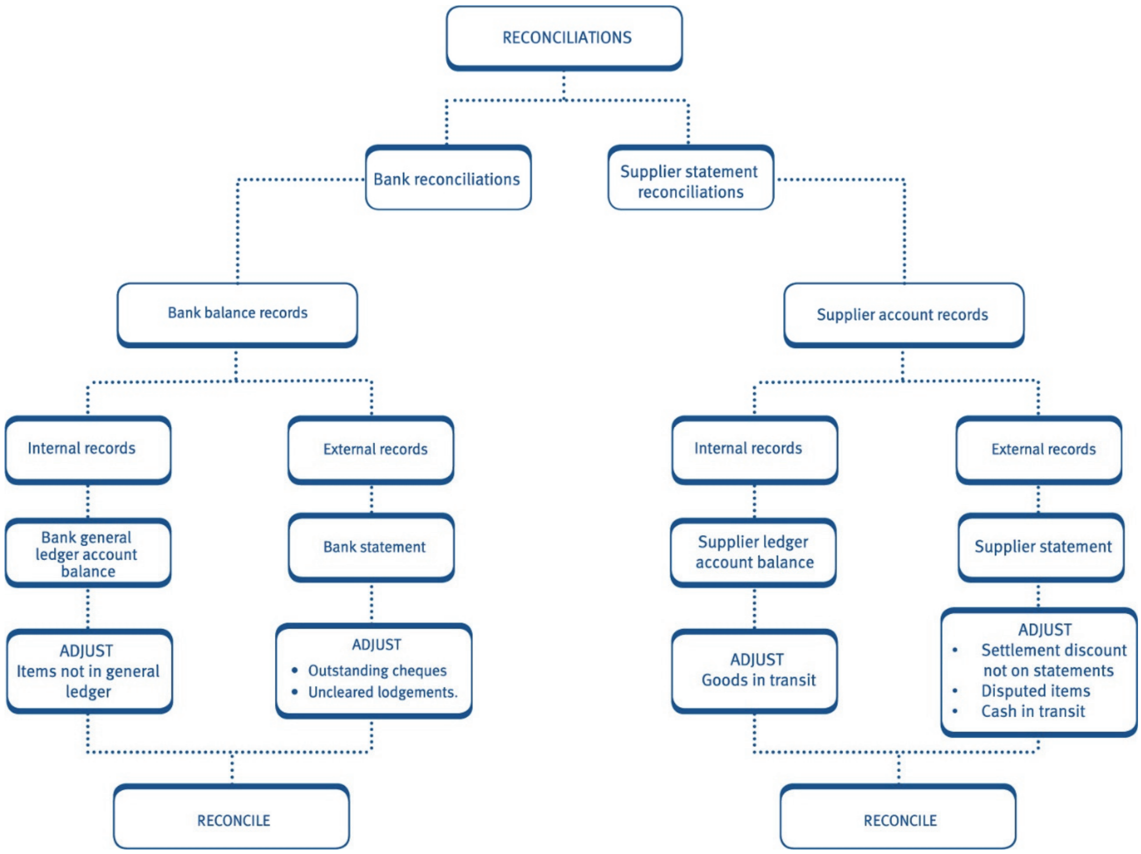
B BDC Co has taken credit for goods returned but this has not yet been recorded by SWY Co

C An invoice from SWY CO has not been recorded by BDC Co

D BDC Co made a payment to SWY Co of $206.72

Test your understanding 6
JAX CO received a statement of account from a supplier showing a balance outstanding of $777. Jax Co's payable account for that supplier shows a balance of $852. **What could be a possible reason for the difference between the two documents?** A The supplier has allowed discount of $75 which JAX Co has not yet recorded B JAX Co has made a payment of $75 which has not yet been received and recorded by the supplier C JAX Co has returned goods to the supplier for a refund or credit note D The supplier has issued an invoice which JAX Co has not yet received

6 Chapter summary



Test your understanding answers

Test your understanding 1

Cash at bank ledger account

	$		$
Bank interest	X	Bank charges	X
Direct credits	X	Direct debits/standing orders	X
		Dishonoured cheques	X

Test your understanding 2

The correct answer is B

Test your understanding 3

Bank reconciliation statement as at 1 December	$
Balance per bank statement	17,478
Less: Outstanding cheques ($426 + $737)	(1,163)
Add: Outstanding lodgements	176
	–––––
Balance per cash at bank ledger account	16,491

Cash at bank account

	$		$
Balance b/f	19,973	Deposit difference ($529 – 528)	1
Error – cheque 783 ($221–212)	9	Bank charges	47
		Rates – s/order	137
		Revised balance c/f	19,797
	–––––		–––––
	19,982		19,982
	–––––		–––––
Revised balance b/f	19,797		

Bank reconciliation statement as at 31 December	$
Balance per bank statement	19,738
Less: Outstanding cheques ($97 + 260)	(357)
Add: Outstanding lodgements (Fred)	119
Bank error (Cheque 310923)	297
	———
Balance per cash at bank ledger account	19,797
	———

Test your understanding 4

The correct answer is D

Cash at bank ledger account

	$		$
Adjustment re cheque (4)	60	Balance b/f	554
Balance c/f	674	Bank charges (1)	136
		Adjustment re paid cheque entered as receipt (3)	44
	———		———
	734		734
	———		———
		Balance b/f	674

Bank reconciliation statement as at 31 December 20X6

	$
Balance per bank statement at 31 December 20X6 (derived)	(407)
Less: Cheques issued but not yet presented (2)	(267)
	———
Balance per cash at bank ledger account at 31 Dec 20X6	(674)
	———

Test your understanding 5

The correct answer is C

1. If BDC Co had made a payment or had taken credit for goods returned, that would be recorded on the payables ledger account, which is not the case here. There are no arithmetic errors in the statement prepared by SWY Co.

Test your understanding 6

The correct answer is A

You think that you owe $75 more than the supplier has stated. With items B, C and D, the result would be that the supplier will state that you owe more, not less. If the supplier has recorded discount allowed to JAX Co which has not yet been recorded, this will reduce the amount owed by JAX Co.

Chapter

14

The trial balance, errors and suspense accounts

Chapter learning objectives

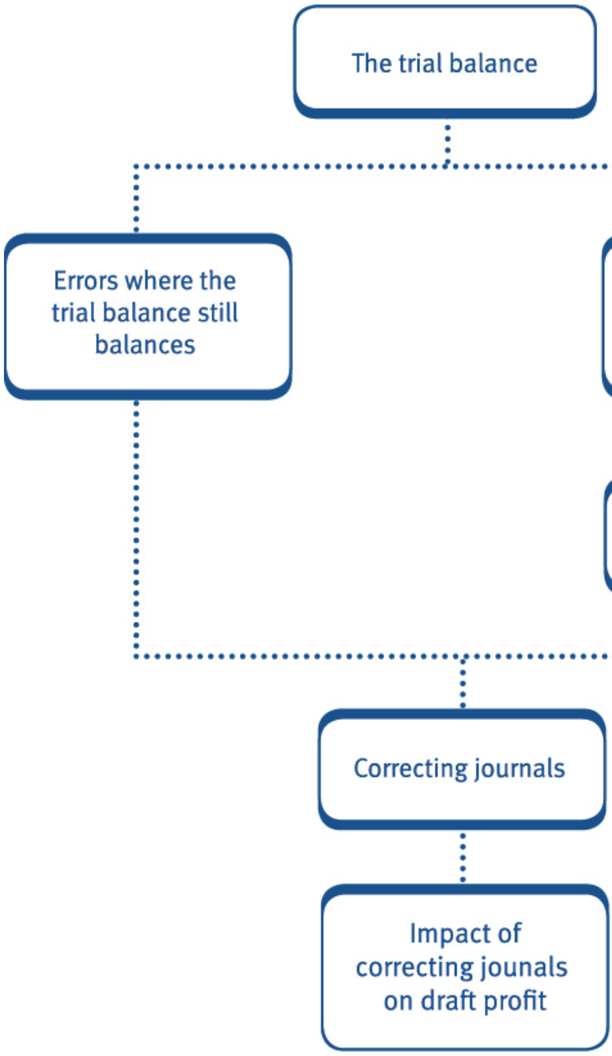
Upon completion of this chapter you will be able to:

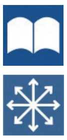
- describe the purpose of and extract a trial balance
- identify the types of error which may occur in accounting systems
- identify the types of error which would and would not be highlighted by a trial balance
- explain the purpose of a suspense account
- identify issues leading to the creation of a suspense account and record entries in a suspense account
- prepare journal entries to correct errors and clear out a suspense account
- understand and calculate the impact of errors or adjustments on the financial statements.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview





Introduction

This chapter deals with collation of ledger account balances into a trial balance, along with consideration of how errors in accounting records may arise and how they are corrected.

Much of the content of this chapter is new. Correction of errors and accounting adjustments are an important topic in your future ACCA studies, in particular for Financial Reporting and Strategic Business Reporting.

2 The trial balance

At the end of the year, when all general ledger accounts have been balanced off, the closing balances are summarised on a list of balances. This is referred to as a trial balance.

All the closing debit balances are summarised in one column and the closing credit balances in another. Given the nature of the double-entry system described in this text the totals of both columns should agree. If not, the difference will be presented as a 'Suspense account'.

This is another control in the accounting system to ensure that the balances reported in the financial statements are reliable. The layout of a trial balance is illustrated below:

Trial balance as at 31 December 20X5

	Debit	**Credit**
	$	$
Revenue		X
Inventory at 1 January 20X5	X	
Purchases	X	
Administrative expenses	X	
Property plant and equipment	X	
Trade receivables	X	
Bank	X	
Share capital		X
Share premium		X
Retained earnings		X
Loans		X
Trade payables		X
Bank overdraft		X
	X	X

Depending upon the size of an entity and other factors, such as the complexity of its business activities, the trial balance of an entity may contain any number of general ledger account balances.

3 The process of preparing financial statements

The process for preparing financial statements can be illustrated as follows:

TRANSACTIONS RECORDED IN LEDGER ACCOUNTS

LEDGER ACCOUNTS BALANCED AND CLOSED OFF

TRIAL BALANCE EXTRACTED

YEAR END ADJUSTMENTS MADE AND LEDGER ACCOUNTS CLOSED OFF

TRIAL BALANCE USED TO PREPARE FINANCIAL STATEMENTS

Examination questions may draw upon any stage of this process.

Test your understanding 1

GAT Co commenced business and in the first nine days of trading the following transactions occurred:

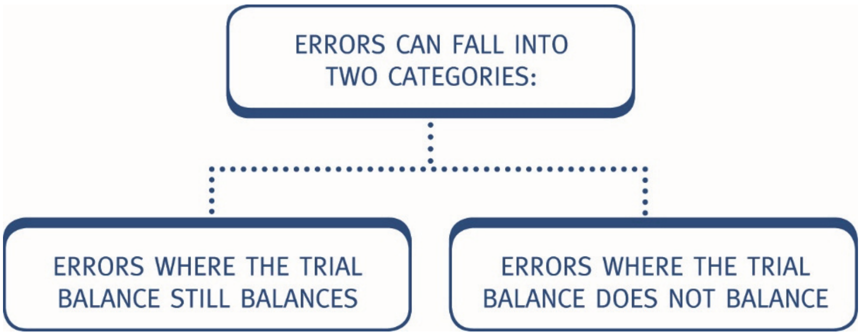
1 January	It issued $10,000 share capital to investors and banked the receipts.
2 January	It purchased goods for $4,000 and paid by bank transfer.
3 January	It bought a delivery van for $2,000 and paid by cheque.
4 January	It purchased $1,000 of goods on credit.
5 January	It sold goods for $1,500 cash, which was banked.
6 January	It sold all remaining goods for $5,000 on credit.
7 January	It paid $800 to suppliers by cheque.
8 January	It paid rent of $200 by bank transfer.

Required:

(a) Complete the relevant ledger accounts.

(b) Extract a trial balance.

4 Types of error



This shows that whilst the trial balance provides a useful control mechanism for detecting errors, a balanced trial balance does not guarantee the accuracy of the financial statements.

Errors where the trial balance still balances

- **Error of omission**: A transaction has been completely omitted from the general ledger, e.g. a supplier purchase invoice of $100 was not recorded.
- **Error of commission:** A transaction has been recorded in the wrong account, e.g. rates expense of $500 was debited to the wages account in error, perhaps because the wrong general ledger code was applied to one of the accounting entries required.
- **Error of principle:** A transaction has been recorded incorrectly in a way which breaches an accounting principle, e.g. a non-current asset purchase of $10,000 was debited to the repair expense account rather than to an asset account, perhaps due to not understanding the nature of the transaction.
- **Compensating error:** Two errors have been made which cancel each other out, e.g. a repair expense of $670 was recorded in the general ledger as $760, and an insurance expense of $1,100 was recorded in the general ledger as $1,010. One expense was overstated by $90, and the other expense understated by the same amount.
- **Error of original entry (transposition error):** The correct double-entry has been made but using the wrong monetary amount, e.g. a credit purchase of $985 was recorded as $859 in the general ledger.
- **Reversal of entries:** The correct amount has been posted to the correct accounts but on the wrong side, e.g. a cash sale of $200 has been debited to revenue and credited to cash at bank in the general ledger.

When correcting these errors, a good approach is to consider:

1 What should the double-entry have been? ('should do').

2 What double-entry was made? ('did do').

3 Therefore, what correction is required? ('to correct').

Always assume that if one side of the double-entry is not mentioned, it has been recorded correctly.

Test your understanding 2

Several accounting errors are noted below:

1 A cash sale of $100 was not recorded.

2 Insurance policy premium paid for $500, was debited to the rent account in error.

3 A non-current asset purchase of $1,000 on credit has been debited to the repairs expense account rather than an asset account.

4 Goods purchased and paid at a cost of $950 was debited to the sales account.

5 A cash sale of $76 was recorded as $67.

6 A cash sale of $200 was debited to sales and credited to cash at bank.

Required:

State the journal adjustment required to correct each of the errors.

Errors where the trial balance does not balance

Errors that may occur in a manual accounting system, such as posting single-sided entries, or recording transactions with debits and credits of different values are not possible in a computerised accounting system. Similarly, other errors which may occur using a manual accounting system such as miscasting transactions to arrive at an incorrect ledger account balance, omitting a balance when extracting a trial balance or recording the wrong balance in the trial balance cannot occur in a computerised system.

5 Suspense accounts

A suspense account is an account in which debits and/or credits are held temporarily until sufficient information is available for them to be posted to the correct accounts.

There is one key reason why suspense account may be created in a computerised accounting system:

- When a bookkeeper is recording a transaction and is not sure where to post one side of the accounting entries, the suspense account can be used left there until its ultimate destination is established and transferred by a subsequent journal adjustment. Note that a suspense account balance may be either a debit or credit balance, depending upon the circumstances which led to its creation. The suspense account balance must be cleared before final accounts can be prepared.

Example of a trial balance which includes a suspense account:

	$	$
Non-current assets	5,000	
Receivables	550	
Inventory	1,000	
Cash	200	
Payables		600
Loan		2,000
Share capital		4,000
Suspense account		150
	6,750	6,750

Illustration 1 – Suspense accounts

On extracting a trial balance, the accountant of ETT Co noted that there was a suspense account included. A further review of transactions identified additional issues that need to be reviewed and corrected as necessary. The review revealed the following:

1 When a motor vehicle had been purchased during the year the bookkeeper did not know what to do with the debit entry so made the accounting entries Dr Suspense, Cr Cash at bank $21,575.

2 A receipt of $530 from a credit customer, Y, had been correctly posted to the receivables' account but the other part of the double-entry had been posted to the payables account.

3 The bookkeeper was not able to deal with the receipt of $500 from the owner's own bank account, and made the accounting entries Dr Bank and Cr Suspense. Upon enquiry, the bookkeeper was advised that it was additional capital introduced into the business.

4 No accounting entries had been made for a receipt of $800 received from a credit customer MDC Co.

5 A payment of $650 to a credit supplier, NBV Co, had been recorded in the payables account and cash at bank account as $65.

Required:

What journals are required to correct the errors and eliminate the suspense account?

Solution to Illustration 1

Process of clearing a suspense account

The starting position identifies the transactions recorded in the suspense account, and the resultant balance on that account before any adjustments are made:

Suspense account

	$		$
Transaction 1	21,575	Transaction 3	500
		Balance c/f	21,075
	21,575		21,575
Balance b/f	21,075		

We now need to work our way through the information given in numbered points 1 to 5 to correct the errors and clear the suspense account balance.

You need to ask yourself the following questions for each point:

(a) what should the double-entry have been?

(b) what was the double-entry that has been made?

(c) what is the journal we need to correct this?

1 (a) It should have been: Dr Vehicle asset $21,575, Cr Cash at bank $21,575

(b) The posting made was: Dr Suspense $21,575, Cr Cash at bank $21,575.

(c) correction = Dr Vehicle asset $21,575, Cr Suspense $21,575

2 (a) It should have been: Dr Cash at bank $530, Cr Receivables $530

(b) The posting was: Dr Payables $530, Cr Receivables $530

(c) Correction = Dr Cash at bank $530, Cr Payables $530

3 (a) It should have been Dr Cash at bank $500, Cr Equity/capital $500

(b) The posing was: Dr Cash at bank $500, Cr Suspense $500

(c) Correction = Dr Suspense $500, Cr Equity/capital $500

4 (a) It should have been: Dr Cash at bank $800, Cr Receivables $800

(b) The posting was: Dr Nil, Cr Nil

(c) Correction = Dr Cash at bank $800, Cr Receivables $800

5 (a) Should have been Dr Payables $650, Cr Cash at bank $650

(b) The posting was: Dr Payables $65, Cr Cash at bank $65

(c) Correction = Dr Payables $585, Cr Cash at bank $585

Now you can post all of the journals that you have listed under the (c) corrections which affect the suspense account. Note that not all errors affected the suspense account.

When you have done so, you should have the following result:

Suspense account

	$		$
Transaction 1	21,575	Transaction 3	500
		Balance c/f	21,075
	21,575		21,575
Balance b/f	21,075	Journal re Trans 1 – Motor vehicle asset	21,575
Journal re Trans 3 – Capital	500		
	21,575		21,575

Test your understanding 3

Bond Co's trial balance includes a suspense account which contains one half of the double-entry of a transaction on which additional information was required to ensure that it is correctly accounted for.

Land owned by Bond Co was revalued during the year from $20,000 to $25,000. The non-current asset account was updated correctly and other accounting entry was posted to the suspense account pending further investigation.

What accounting entries are required to ensure that the transaction is correctly accounted for?

A	Debit:	Revaluation surplus	Credit:	Suspense
B	Debit:	Suspense	Credit:	Depreciation expense
C	Debit:	Suspense	Credit:	Revaluation Surplus
D	Debit:	Non-current asset	Credit:	Suspense

6 Adjustments to profit

A journal adjustment may result in a change in the draft profit for the year, depending on whether the journal debits or credits an income and/or expense account. Consider the following summary of potential journal adjustments and how each may or may not affect profit for the year:

Dr Statement of financial position account Cr Statement of financial position account	No impact on profit
Dr Profit or loss account Cr Profit or loss account	No impact on profit
Dr Profit or loss account Cr Statement of financial position account	Profit decreases
Dr Statement of financial position account Cr Profit or loss account	Profit increases

For this purpose the suspense account is defined as a statement of financial position account, pending correction of errors etc. before final accounts are produced.

As computerised accounting systems do not usually permit transactions of an unequal value of debits and credits to be processed, the focus is upon transactions which have not been recorded correctly, even though an equal value of debits and credits have been recorded. This includes situations where one part of a transaction has been recorded in the suspense account, pending further review of that transaction.

Consider the following (rather extreme) example of accounting for a cash sale of $1,000 with the following accounting entries made in the general ledger:

Debit Non-current assets $1,000 Credit Trade payables $1,000

An equal value of debits and credits were recorded in the general ledger, and the trial balance will agree, but the accounting entries are wrong. Consequently, the balances for non-current assets and trade payables will be overstated by $1,000. In addition, the balances for the cash at bank balance and revenue will be understated by $1,000. This can be corrected by a journal adjustment.

In this example, the net effect is that revenue and profit for the year in the statement of profit or loss has been understated by $1,000. In the statement of financial position, non-current assets and trade payables have been overstated, and the cash at bank balance has been understated, each by $1,000.

The correcting entries required are as follows:

Debit Cash at bank	$1,000	Credit Non-current assets	$1,000
Debit Trade payables	$1,000	Credit Revenue	$1,000

Test your understanding 4

The following journal adjustments have been posted by BOR Co:

1 Dr Suspense $4,000

Cr Insurance $4,000

2 Dr Payables $2,500

Cr Suspense $2,500

3 Dr Loan interest $1,000

Cr Loan $1,000

4 Dr Suspense $650

Cr Sundry income $650

5 Dr Suspense $6,000

Cr Cash at bank $6,000

BOR Co's draft profit figure prior to the posting of these journals was $355,000.

What is the revised profit figure?

A $354,000

B $358,650

C $356,150

D $358,000

What affect will these correction journals have on the statement of financial position?

7 Statement of comprehensive income

Correction journals may also affect other comprehensive income. In the ACCA FA syllabus and exam, only journals involving revaluation of property, plant and equipment would affect this.

8 Chapter summary

The trial balance

Errors where the trial balance still balances

- Error of omission
- Error of commission
- Error of principle
- Compensating error
- Error of original entry
- Reversal of entries.

Queries on transactions

One part of double-entry held in suspense pending review

CORRECTION JOURNALS

CORRECT THE ERRORS AND REMOVE ANY SUSPENSE ACCOUNT

Impact of correction journals on profit:

Dr Profit or loss Cr Profit or loss	No impact on profit
Dr Statement of financial position Cr Statement of financial position	No impact on profit
Dr Profit or loss Cr Statement of financial position	Profit decreases
Dr Statement of financial position Cr Profit or loss	Profit increases

Test your understanding answers

Test your understanding 1

Cash at bank

		$			$
1 Jan	Share capital	10,000	2 Jan	Purchases	4,000
5 Jan	Revenue	1,500	3 Jan	Delivery van	2,000
			7 Jan	Payables	800
			8 Jan	Rent	200
				Balance c/f	4,500
		11,500			11,500
	Balance b/f	4,500			

Ordinary share capital

		$			$
	Balance c/f	10,000	1 Jan	Cash at bank	10,000
		10,000			10,000
				Bal b/f	10,000

Purchases

		$			$
2 Jan	Cash at bank	4,000		Bal c/f	5,000
4 Jan	Payables	1,000			
		5,000			5,000
	Bal b/f	5,000			

Delivery van

		$			$
1 Jan	Cash at bank	2,000		Balance c/f	2,000
		2,000			2,000
	Balance b/f	2,000			

Payables

		$			$
1 Jan	Cash at bank	800	4 Jan	Purchases	1,000
	Balance c/f	200			
		1,000			1,000
				Balance b/f	200

Revenue

		$			$
	Bal c/f	6,500	1 Jan	Cash at bank	1,500
			6 Jan	Receivables	5,000
		6,500			6,500
				Bal b/f	6,500

Receivables

		$			$
1 Jan	Revenue	5,000		Balance c/f	5,000
		5,000			5,000
	Balance b/f	5,000			

Rent

		$			$
8 Jan	Cash at bank	200		Bal b/f	200
		200			200
	Bal b/f	200			

Trial balance as at 9 January	**Dr**	**Cr**
	$	$
Cash at bank	4,500	
Ordinary share capital		10,000
Purchases	5,000	
Delivery van	2,000	
Payables		200
Revenue		6,500
Receivables	5,000	
Rent	200	
	16,700	16,700

Test your understanding 2

	What should the double-entry have been?	What was the double-entry?	Correcting journal
1	Dr Cash at bank $100 Cr Sales $100		Dr Cash at bank $100 Cr Sales $100 to record both sides of the sale correctly
2	Dr Insurance $500 Cr Cash at bank $500	Dr Rent $500 Cr Cash at bank $500	Dr Insurance $500 to record the insurance expense correctly Cr Rent $500 to reverse the incorrect debit to the rent account

3	Dr NC asset $1,000 Cr Payables $1,000	Dr Repairs $1,000 Cr Payables $1,000	DR NC asset $1,000 to record the asset correctly Cr Repairs $1,000 to reverse the incorrect debit to the repairs account
4	Dr Purchases $950 Cr Cash at bank $950	Dr Sales $950 Cr Cash at bank $950	Dr Purchases to record the expense correctly, and Cr Sales to reverse the incorrect debit to the sales account
5	Dr Cash at bank $76 Cr Sales $76	Dr Cash at bank $67 Cr Sales $67	Dr Cash at bank $9 Cr Sales $9 to record the extra $9 sales not previously recorded
6	Dr Cash at bank $200 Cr Sales $200	Dr Sales $200 Cr Cash at bank $200	Dr Cash at bank $400 Cr Sales $400 to firstly reverse the error of $200 and then record the sale of $200 correctly in both accounts

Test your understanding 3

The correct answer is C

If the non-current asset account was updated correctly, this would be a debit to increase the balance on that account. The other half of the transaction would initially be a credit to the suspense account. To clear the suspense account requires a debit into that account, and a corresponding credit to the revaluation surplus account to complete the correct accounting entries.

Test your understanding 4

The correct answer is B

	$
Draft profit	355,000
1 Insurance	4,000
2 No impact	
3 Loan interest	(1,000)
4 Sundry income	650
5 No impact	
	4,650
Revised profit	358,650

Impact on statement of financial position

Journal 1 – The Dr entry would go towards clearing any Suspense a/c balance.

Journal 2 – The Dr Payables would decrease the current liabilities. The Cr Suspense a/c would go towards clearing the account balance.

Journal 3 – The Cr Loan would increase the loan liability balance. The information does not state whether it is a current or non-current liability.

Journal 4 – The Dr Suspense a/c would work towards clearing any remaining balance.

Journal 5 – Dr Suspense a/c would completely clear the balance in this account. The Cr Cash at bank would decrease the bank balance, which is a current asset.

The following is for reference only – it was not required as part of the answer deriving the initial balance on the suspense account and demonstrating how it was cleared.

Suspense

	$		$
Rent	4,000	Bal b/f	8,150
Sundry income	650	Payables	2,500
Cash at bank	6,000		
	10,650		10,650

Chapter

15

Preparing basic financial statements

Chapter learning objectives

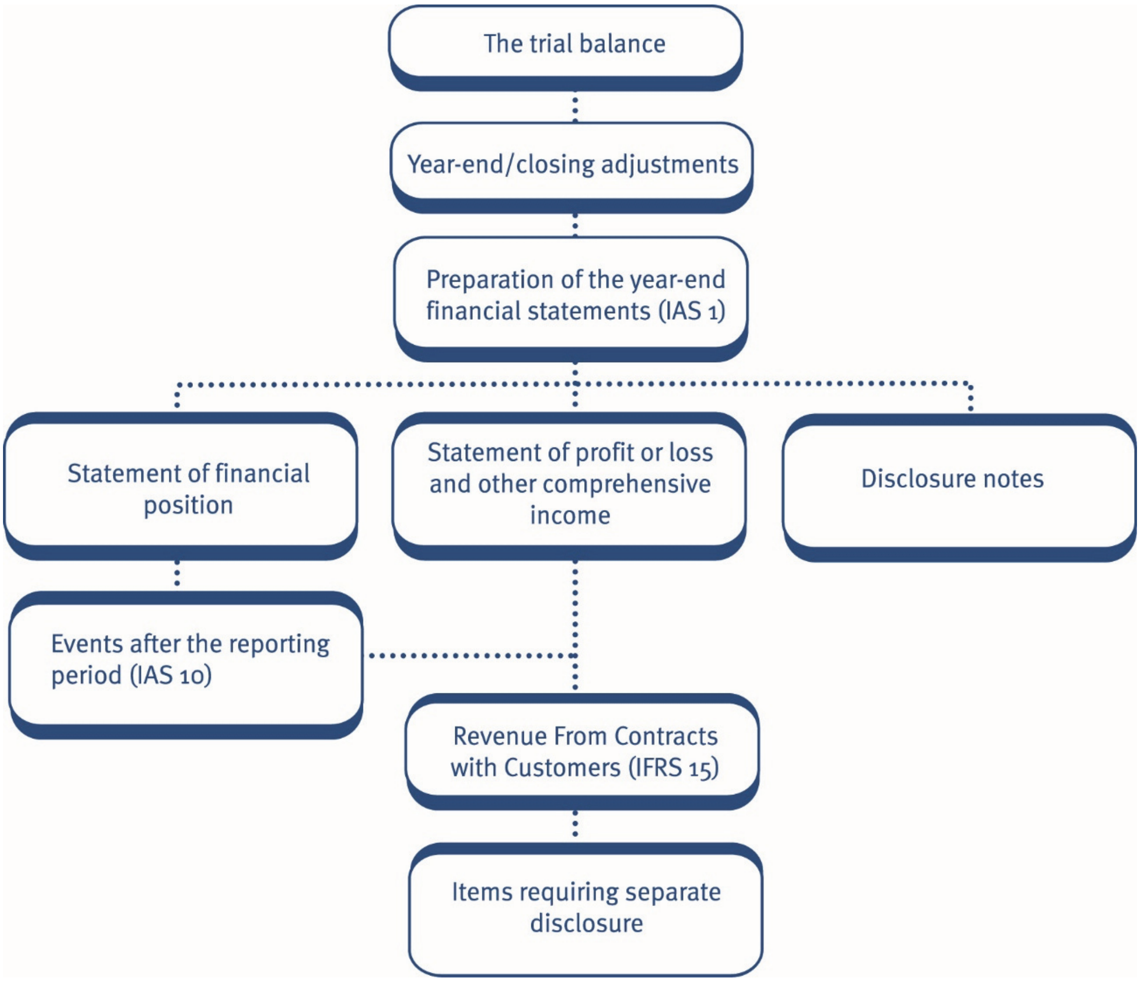
Upon completion of this chapter you will be able to:

- prepare a statement of financial position and statement of profit or loss and other comprehensive income (or extracts) from given information
- understand, identify and report reserves in a company statement of financial position
- understand the interrelationship between the main financial statements
- identify items requiring separate disclosure on the face of the statement of profit or loss
- explain the purpose of disclosure notes
- define and classify events after the reporting period as either adjusting or non-adjusting events.

PER

One of the PER performance objectives (PO7) is to prepare and review financial statements in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



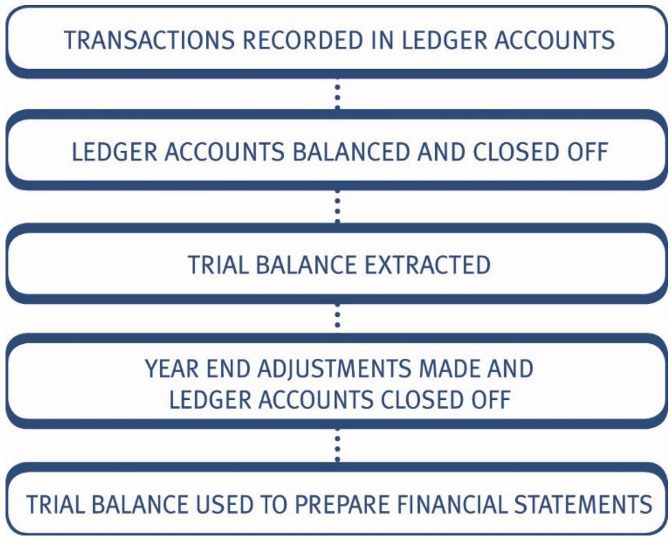
Introduction

This chapter builds on the content of the previous chapter to demonstrate the processes required to prepare financial statements for either a sole trader or a limited liability company.

The preparation of financial statements for a limited liability company is a key element of the syllabus content for both Financial Reporting and Strategic Business Reporting.

2 The process of preparing financial statements

In the previous chapter we introduced the process for preparing financial statements:



By this stage you should be familiar with the double-entry bookkeeping process, closing off the ledger accounts and extracting a trial balance. In this chapter we will explore the adjustments commonly made at the end of the accounting period after the initial trial balance has been drafted and then consider how the financial statements are prepared from this information.

3 Adjustments to the initial trial balance

As well as adjusting the trial balance figures for any errors identified there are also a number of common adjustments made at the end of the accounting period. These include:

- closing inventory (chapter 5)
- depreciation charge for the year (chapter 6)
- accruals and prepayments (chapter 10)
- irrecoverable debts and allowances for receivables (chapter 11)
- provisions and contingent liabilities (chapter 12)
- income tax (chapter 13), and
- events after the reporting period (chapter 15).

These adjustments need to be processed before the financial statements can be created.

Common accounting adjustments (recap)

Examples of the more common accounting adjustments include:

(i) Closing inventory (Chapter 5)

Dr Inventory (SFP)

Cr Cost of sales (P/L)

(ii) Depreciation charge for the year (Chapter 6)

Dr Depreciation expense (P/L)

Cr Accumulated depreciation (SFP)

(iii) Accruals (Chapter 9)

Dr Expenses (P/L)

Cr Accrual (Liability) (SFP)

(iv) Prepayments (Chapter 9)

Dr Prepayment (Current Asset) (SFP)

Cr Expenses (P/L)

(v) Irrecoverable debts (Chapter 10)

Dr Irrecoverable debt expense (P/L)

Cr Receivables (SFP)

(vi) Allowance for receivables (Chapter 10)

Increase in allowance

Dr Irrecoverable debt expense (P/L)

Cr Allowance for receivables (SFP)

Decrease in allowance

Dr Allowance for receivables (SFP)

Cr Irrecoverable debt expense (P/L)

(vii) Tax estimate for the year (Chapter 12)

Dr Tax charge (P/L)

Cr Current tax liabilities (SFP)

(viii) Adjustments for prior year tax estimates (Chapter 12)

Overprovision in prior year

Dr Current tax provision (SFP)

Cr Tax charge for the year (P/L)

Under provision in prior year

Dr Tax charge for the year (P/L)

Cr Current tax provision (SFP)

4 IAS 1 Presentation of Financial Statements

The required formats for published company financial statements are provided by IAS 1 Presentation of Financial Statements. This requires the following components to be presented:

- a statement of financial position
- a statement of profit or loss
- a statement of other comprehensive income
- a statement of changes in equity
- notes to the financial statements, and
- a statement of cash flows.

The components of the financial statements will be considered in this chapter and also Chapter 17 'Statement of cash flows'.

5 The statement of financial position

This summarises the asset, liability and equity balances (i.e. the financial position of the entity) at the end of the accounting period. In effect, this is a standardised and summarised representation of the accounting equation that was covered in the early chapters of this publication.

Note that IAS 1 that requires that assets and liabilities must be classified as either current or non-current in the statement of financial position.

Statement of financial position for XYZ Co at 31 December 20XX

	$m	$m
Non-current assets		
Property, plant and equipment	X	
Investments	X	
Intangibles	X	
	——	X
Current assets		
Inventories	X	
Trade and other receivables	X	
Prepayments	X	
Cash at bank	X	
	——	X
		——
Total assets		**X**
		——

Equity	X	
Ordinary share capital	X	
Irredeemable preference share capital	X	
Share premium	X	
Revaluation surplus	X	
Retained earnings	X	
	——	
		X
Non-current liabilities		
Loan notes		X
Current liabilities		
Trade and other payables	X	
Overdrafts	X	
Tax payable	X	
	——	
		X
		——
Total equity and liabilities		**X**
		——

Current assets and current liabilities

The suggested statement of financial position format makes a distinction between current and non-current assets and liabilities. IAS 1 sets down the rules to be applied in making this distinction.

Current assets

An asset should be classified as a current asset if it is:

- held primarily for trading purposes
- expected to be realised within 12 months of the statement of financial position date; or
- cash or a cash equivalent (i.e. a short term investment, such as a 30 day bond).

All other assets should be classified as non-current assets.

Note that this definition allows inventory or receivables to qualify as current assets under (a) above, even if they may not be realised into cash within twelve months.

Current liabilities

The rules for current liabilities are similar to those for current assets.

A liability should be classified as a current liability if:

- it is expected to be settled in the normal course of the enterprise's operating cycle
- it is held primarily for the purpose of being traded
- it is due to be settled within 12 months of the statement of financial position date or
- the company does not have an unconditional right to defer settlement for at least 12 months after the statement of financial position date.

All other liabilities should be classified as non-current liabilities.

6 The statement of profit or loss

This summarises the income earned and expenses incurred during the financial period.

XYZ Co

Statement of profit or loss for the year ended 31 December 20XX

	$
Revenue	X
Cost of sales	(X)
Gross profit	X
Distribution costs	(X)
Administrative expenses	(X)
Profit from operations	X
Investment income	X
Finance costs	(X)
Profit before tax	X
Tax expense	(X)
Net profit for the period	X

7 The statement of profit or loss and other comprehensive income

This is simply an extension of the statement of profit or loss. The reason for this is that some gains made by the entity during the year are not realised gains. The best example of this is the revaluation of tangible non-current assets.

The gain is not realised until the asset is sold and converted into cash. The revaluation represents a hypothetical gain (i.e. what gain would be made if the asset was sold at the date of the revaluation).

For this reason it should not be included in net profit for the period, which represents the profit earned from realised sales. Instead the unrealised gains are added onto the end of the statement of profit or loss, as follows:

Statement of profit or loss and other comprehensive income for XYZ for the year ended 31 December XXXX

	$m
Revenue	X
Cost of sales	(X)
Gross profit	X
Distribution costs	(X)
Administrative expenses	(X)
Profit from operations	X
Investment income	X
Finance costs	(X)
Profit before tax	X
Tax expense	(X)
Net profit for the period	X
Other comprehensive income	
Items that will not be reclassified to profit or loss in future periods:	
Gain/loss on property revaluation in the year	X(X)
Total comprehensive income for the year	**X**

Note that an entity can choose to present the above information in the form of two separate statements:

- the statement of profit or loss for the year, and
- the statement of other comprehensive income for the year.

Items requiring separate disclosure

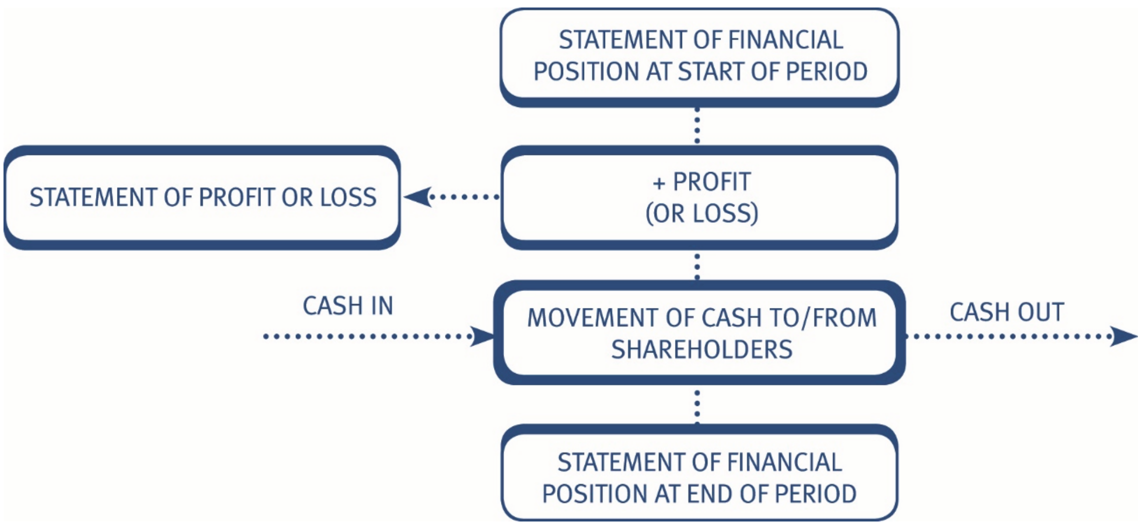
Certain items need to be separately disclosed on the face of the statement of profit or loss, or else disclosed in the notes to the financial statements, so that they are clearly visible to the users of the financial statements. The main items requiring such treatment are significant, one-off transactions or events. They need to be disclosed because they are not part of the normal trading activity of the business and could significantly distort the reported profits or losses for the year. They include:

- cost of restructuring or reorganisation of the company
- profits or losses on disposal of property, plant and equipment (or investments), and
- impairments of inventory, property, plant and equipment.

All such items should be included on its own separate line in the statement of profit or loss.

Relationship between the statement of profit or loss and statement of financial position

The link between the statement of financial position and the statement of profit or loss is shown below:



8 The statement of changes in equity

Equity represents the owners' interests in the company. An alternative way of defining it is that it represents what is left in the company when it ceases to trade, all the assets are sold off and all the liabilities are paid. Any surplus remaining can then be distributed to the equity holders (ordinary shareholders).

Equity comprises share capital, share premium, and reserves. The main reserves are the revaluation surplus and retained earnings.

Revaluation surplus

This is created to recognise the surplus arising when tangible non-current assets (normally land and buildings) are revalued (for more detail see Chapter 7). The gain is not realised so cannot be included in the retained earnings of the entity. However, the gain would still form part of the value repaid to the equity holders if the company was to be sold off at that point in time.

Retained earnings

This represents the sum total of all the profits and losses made by the company since its incorporation and that have not yet been paid to shareholders as a dividend.

As these elements are particularly relevant to shareholders (it helps them value their wealth or 'share of the pie') it is important to ensure the shareholders understand any movements in these balances. For this reason a statement of changes in equity is required. It summarises the opening and closing positions on all equity accounts and identifies the reason(s) for any movements during the year.

Statement of changes in equity for XYZ Co

	Share capital	**Share premium**	**Revaluation surplus**	**Retained earnings**	**Total**
	$m	$m	$m	$m	$m
Balance at 1 January	X	X	X	X	X
Equity shares issued	X	X			X
Revaluation surplus in year			X		X
Net profit				X	X
Dividends paid				(X)	(X)
Bal at 31 Dec	X	X	X	X	X

9 Disclosure notes

Disclosure notes are required for a variety of reasons, such as:

- to explain the accounting policies used when preparing the accounts
- to explain the movement between the opening and closing balances of major statement of financial position items
- to show how certain balances are complied, and
- to provide further detail/explanation to users of the financial statements, as necessary for the accounts to be understandable to the users.

For this exam you do not need to know the presentation of all the relevant disclosure notes that support the financial statements. The notes you do need to know and the chapters they are explained in are as follows:

- Inventory (Chapter 5)
- Non-current tangible and intangible assets (Chapters 6 & 7)
- Provisions (Chapter 11) and
- Events after the reporting period (this chapter).

10 Preparation of financial statements and the exam

The following example requires the preparation of a statement of profit or loss and a statement of financial position from a trial balance and adjustments.

Illustration 1 – Preparation of financial statements

The trial balance of Crown Co as at 31 December 20X5 was as follows:

	Dr	Cr
	$	$
Ordinary share capital		100,000
Sales and purchases	266,800	365,200
Inventory at 1 January 20X5	23,340	
Returns	1,200	1,600
Wages	46,160	
Rent	13,000	
Motor expenses	3,720	
Insurance	760	
Irrecoverable debts	984	
Allowance for receivables		
1 January 20X5		588
Sundry income		1,622
Light and heat	3,074	
Bank overdraft interest	74	
Motor vehicles at cost	24,000	
– accumulated depreciation		
1 Jan 20X5		12,240
Fixtures and fittings at cost	28,000	
– accumulated depreciation		
1 Jan 20X5		16,800
Land	100,000	
Receivables and payables	17,330	23,004
Bank	3,312	
Income tax under provision	100	
Buildings at cost	100,000	
– aggregate depreciation:		
1 Jan 20X5		6,000
Retained earnings at 1 Jan 20X5		104,800
	631,854	631,854

You are given the following additional information:

1 Inventory at 31 December 20X5 was $25,680.

2 Rent was prepaid by $1,000 and light and heat owed was $460 at 31 December 20X5.

3 Land is to be revalued to $250,000 at 31 December 20X5.

4 Following a final review of the receivables at 31 December 20X5, Crown Co decided to write off another debt of $130. The entity also adjusted the allowance for receivables to $516 at 31 December 20X5.

5 Crown Co estimated that the income tax charge on profit for the year was $7,300.

6 Depreciation is to be provided as follows:

(a) building – 2% annually, straight-line

(b) fixtures & fittings – straight line method, assuming a useful economic life of five years with no residual value

(c) motor vehicles – 30% annually on a reducing balance basis.

A full year's depreciation is charged in the year of acquisition and none in the year of disposal.

Required:

Prepare a statement of profit or loss and other comprehensive income for the year ended 31 December 20X5 and a statement of financial position as at that date for Crown Co.

Solution to Illustration 1

Statement of profit or loss and other comprehensive income for the year ended 31 December 20X5

	$
Revenue ($365,200 – $1,200)	364,000
Cost of sales (W1)	(262,860)
Gross profit	101,140
Sundry income	1,622
Administrative expenses (W2)	(78,418)
Profit before tax	24,344
Income tax charge (W3)	(7,400)
Profit for the year	16,944
Other comprehensive income:	
Revaluation surplus in year	150,000
Total comprehensive income	166,944

Statement of financial position as at 31 December 20X5

	$	$
Non-current assets		
Property, plant and equipment (W5)		355,832
		355,832
Current assets		
Inventory	25,680	
Trade receivables (W6)	16,684	
Prepayments	1,000	
Cash at bank	3,312	
		46,676
		402,508

Equity		
Ordinary share capital	100,000	
Revaluation surplus ($250,000 – $100,000)	150,000	
Retained earnings ($104,800 + $16,944)	121,744	
		371,744
Current liabilities		
Income tax liability (W3)	7,300	
Trade payables	23,004	
Accrued expenses	460	
		30,764
		402,508

Workings:

(W1) Cost of sales

	$
Opening Inventory	23,340
Purchases	266,800
Purchase returns	(1,600)
	288,540
Closing inventory	(25,680)
	262,860

(W2) Administrative expenses

	$
Wages	46,160
Rent ($13,000 – $1,000)	12,000
Motor expenses	3,720
Insurance	760
Irrecoverable debts ($984 + $130)	1,114
Decrease in allowance for receivables (W6)	(72)
Light and heat ($3,074 + $460)	3,534
Bank interest	74
Depreciation (W4)	11,128
	78,418

(W3) Income tax

	$
Under provision re previous year per trial balance	100
Income tax on profit for year (and year-end liability)	7,300
	7,400

(W4) Depreciation charge for year

	P&L charge	Prov'n b/fwd	Prov'n c/fwd
	$	$	$
Buildings ($100,000 × 2%)	2,000	6,000	8,000
Fixtures and fittings ($28,000 × 20%)	5,600	16,800	22,400
Vehicles (($24,000–$12,240) ×30%)	3,528	12,240	15,768
	11,128		

(W5) Non-current assets

	Cost or val'n	Acc dep'n		CA
	$	$		$
Land (valuation in year)	250,000	–		250,000
Buildings	100,000	8,000	(W4)	92,000
Fixtures and fittings	28,000	22,400	(W4)	5,600
Motor vehicles	24,000	15,768	(W4)	8,232
	402,000	46,168		355,832

(W6) Trade receivables

	$
Receivables ($17,330 – $130 w/off)	17,200
Allowance for receivables c/fwd	(516)
	16,684
Movement in allowance for receivables:	
Balance b/fwd	588
Balance c/fwd (as per above)	516
Decrease in allowance to P&L	(72)

Test your understanding 1

The trial balance of Penguin Co as at 31 December 20X5 was as follows:

	Dr	Cr
	$	$
Sales and purchases	20,000	50,000
Inventory	8,000	
Distribution costs	8,000	
Administration expenses	15,550	
Receivables and payables	10,000	20,000
Fundamental reorganisation costs	2,400	
Cash at bank	7,250	
Ordinary shares 50c		8,000
10% irredeemable preference shares $1		9,000
10% loan notes		8,000
Non-current assets at carrying amount	35,000	
Share premium		3,000
Accumulated profits at 1 January 20X5		3,000
Loan note Interest paid	800	
Preference dividend paid	900	
Interim ordinary dividend paid	1,600	
Tax		500
Suspense		8,000
	109,500	109,500

The following is to be taken into account.

1 A building whose carrying amount is currently $5,000 is to be revalued to $11,000.

2 A final ordinary dividend of 10c per share is to be proposed.

3 The balance on the income tax account represents an overprovision of tax for the previous year. Tax for the current year is estimated at $3,000.

4 Closing inventory is $12,000.

5 The balance on the suspense account represents the proceeds from the issue of 4,000 ordinary shares.

Prepare the following financial statements of Penguin Co for the year ended 31 December 20X5:

1 **statement of profit or loss and other comprehensive income**

2 **statement of financial position**

3 **statement of changes in equity.**

Test your understanding 2

Ali Page prints and publishes study materials. Ali prepared the following trial balance as at 30 June 20X7:

	Dr	Cr
	$	$
Purchases	60,000	
Inventory at 1 July 20X6	10,000	
Sales		120,000
Distribution costs	13,200	
Administrative and selling expenses	5,600	
Trade receivables	12,200	
Irrecoverable debts	1,550	
Bank balance		4,150
Capital account at 1 July 20X6		73,100
Discount received		2,500
6% Bank loan		10,000
Non-current assets at carrying amount	102,500	
Capital introduced in the year		5,000
Loan interest paid	300	
Drawings	8,000	
Trade payables		5,600
Wages	15,000	
Suspense		8,000
	228,350	228,350

The following is to be taken into account.

1 Inventory valuation at 30 June 20X7 was $12,000.

2 Ali decided to write off an irrecoverable debt of $1,000. This should be accounted for as an administrative and selling expense.

3 The wages cost should be split equally between cost of sales and administrative and selling expenses.

4 The bank loan was taken out on 1 July 20X6.

5 The depreciation charge for the year of $5,000 on property, plant and equipment has not yet been accounted for. It should be classified as a cost of sale.

6	The balance on the suspense account represents the proceeds from the disposal of an item of property, plant and equipment. At the date of disposal, that item had a net carrying amount of $10,000. The gain or loss on disposal should be accounted for as a cost of sale.

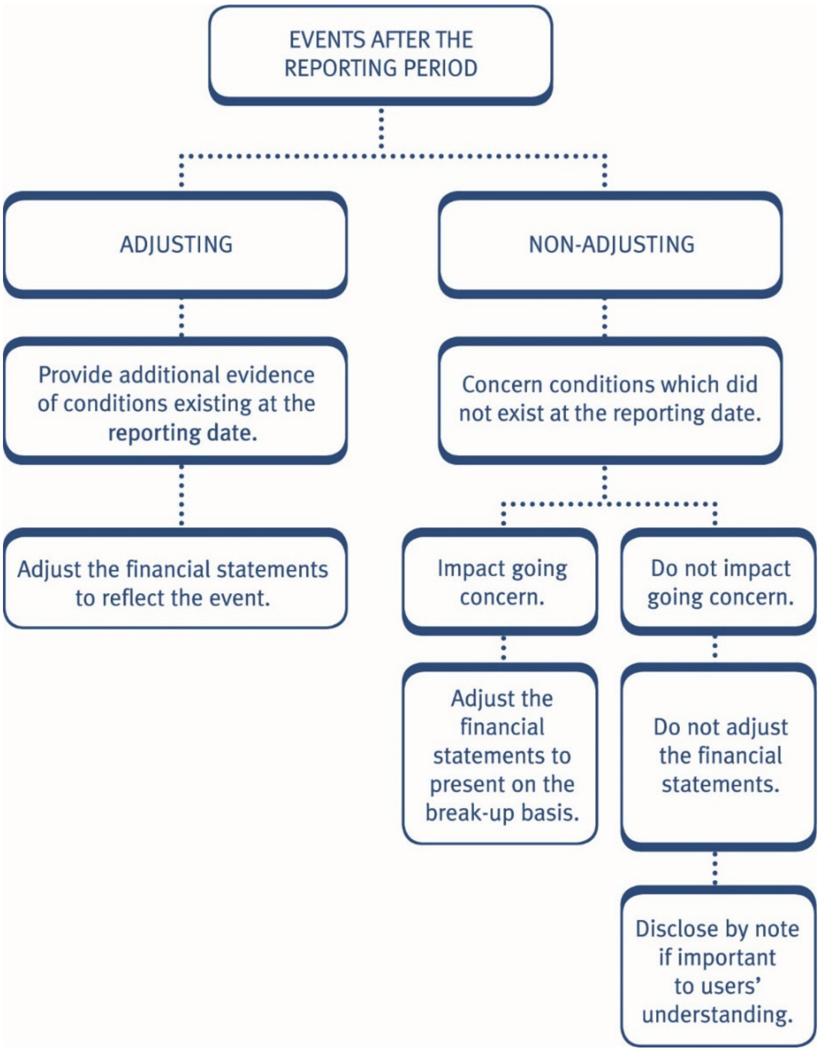
Prepare the statement of profit or loss for the year ended 30 June 20X7, together with the statement of financial position as at 30 June 20X7 on behalf of Ali Page.

11 Events after the reporting period (IAS 10)

IAS 10 Events After the Reporting Period defines events after the reporting period as **'those events, favourable and unfavourable, that occur between the end of the reporting period and the date when the financial statements are authorised for issue'** (IAS 10, para 3).

Adjusting and non-adjusting events

According to IAS 10, Events After the Reporting Period, adjusting and non-adjusting events are classified and treated as follows:



Adjusting and non-adjusting events

Adjusting events

These events provide additional evidence of conditions existing at the reporting date. For example, any receivables at the reporting date which are subsequently regarded as possibly not being collectable may help to quantify the allowance for receivables required as at the reporting date. If a material adjusting event is identified, the financial statements must be amended to reflect the relevant condition.

Examples of adjusting events

- The settlement after the reporting date of a court case which confirms a year end obligation.
- The receipt of information after the reporting date that indicates that an asset was impaired at the reporting date.
- The bankruptcy of a customer after the reporting date that confirms that a year-end debt is irrecoverable.
- The sale of inventories after the reporting period at a price lower than cost.
- The determination after the reporting date of the cost of assets purchased or proceeds from assets sold before the reporting date.
- The discovery of fraud or errors showing that the financial statements are incorrect.

Non-adjusting events

These are events arising after the reporting date but which do not concern conditions existing at the reporting date. Such events will not, therefore, have any effect on items in the statement of profit or loss or statement of financial position. However, in order to prevent the financial statements from presenting a misleading position, some form of additional disclosure is required if the events are material, by way of a note to the financial statements giving details of the event.

Examples of non-adjusting events

- Announcing a plan to discontinue an operation.
- Major purchases of assets.
- The destruction of assets after the reporting date by fire or flood (unless the extent of loss is such that the entity may not be able to continue as a going concern, in which case the basis upon which the financial statements are prepared may need to be questioned).
- Entering into significant commitments or contingent liabilities.
- Commencing a court case arising out of events after the reporting date.

Test your understanding 3

Which of the following are adjusting events for Big Co? The accounting year end is 30 June 20X6 and the financial statements are approved by the directors on 18 August 20X6.

1 Sales of year-end inventory on 2 July 20X6 were at less than cost.

2 The issue of new equity shares on 4 July 20X6.

3 A fire in the main warehouse occurred on 8 July 20X6. A small quantity of inventory was destroyed.

4 A major credit customer was declared bankrupt on 10 July 20X6.

5 All of the share capital of a competitor, Teeny Co was acquired on 21 July 20X6.

6 On 1 August 20X6, $500,000 was received in respect of an insurance claim dated 13 February 20X6.

A 1, 4 and 6

B 1, 2, 4 and 6

C 1, 2, 5 and 6

D 1, 4, 5 and 6

Disclosure of material, non-adjusting events

According to IAS 10, if a non-adjusting event is identified and it is material (i.e. significant to the decision making of users) it should be disclosed by way of a note to the financial statements. The note should describe:

(i) the nature of the event

(ii) an estimate of the financial effect, or a statement that such an estimate cannot be made.

12 Revenue from Contracts with Customers (IFRS 15)

Recognition of revenue is vital to the fair presentation of the financial statements. For many entities, the revenue figure is the largest single financial value included in their financial statements. With most transactions it is relatively easy to determine when, and how much, revenue has been earned.

However, for some entities, this is not always easy to determine or quantify, and some entities have adopted a range of accounting treatments in an effort to comply with the reporting requirements. For example, if an entity supplies a bundle or combination of goods and/or services to a customer, it can be more difficult to identify when and how much revenue has been earned and when it should be recognised in the financial statements.

Revenue should be stated in the financial statements excluding sales tax and also excluding any amounts collected on behalf of others.

For example, a travel agent receives a holiday booking from a client for an all-inclusive price of $3,000, on which the agent is entitled to 10% commission. The travel agent will recognise revenue of $300, with the balance of $2,700 accounted for as a liability due to the holiday company. The holiday company will recognise revenue of $3,000 less the expense of $300 commission due to the travel agent.

IFRS 15 Revenue from Contracts with Customers provides a five-step approach to revenue recognition and clarifies when revenue from various sources may be recognised. This should help entities to determine revenue recognition on a more consistent and comparable basis.

Revenue is defined as **'income arising in the course of an entity's ordinary activities'** IFRS 15, Appendix A).

The five-step approach for revenue recognition

Revenue from the sale of goods and/or provision of services should be recognised based upon application of the five-step approach:

1. Identify the contract
2. Identify the separate performance obligations within a contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations in the contract
5. Recognise revenue when (or as) a performance obligation is satisfied.

Each of the five steps will be considered in turn using the following illustration to help you gain an understanding of the basic principles.

Illustration

On 1 December 20X1, Wad Co received an order from a customer for the purchase of a computer plus technical support for 12 months. Wad Co delivered the computer (and transferred control of the computer) on 1 December 20X1. The customer paid a total of $420 immediately, which comprised $300 for the computer and $120 for technical support. Both the computer and technical support could be purchased separately. Wad Co has an accounting year end of 31 March 20X2.

Below is how the five steps would be applied to this transaction:

Step 1 – Identify the contract

There is an agreement between Wad Co and its customer for the provision of goods (supply of computer) and services (twelve months of technical support).

Step 2 – Identify the separate performance obligations within a contract

There are two performance obligations (promises) within the contract:

- Wad Co has agreed to supply a computer
- Wad Co has agreed to the supply of technical support for 12 months

Step 3 – Determine the transaction price

The total transaction price agreed was $420.

This step is important for revenue recognition as, if credit customers are offered an early settlement discount, the amount of revenue receivable will be variable, depending upon whether or not the credit customer takes advantage of the early settlement discount terms. This is considered in more detail in chapter 4 'Recording transactions and events'.

Step 4 – Allocate the transaction price to the separate performance obligations in the contract

Based upon the individual sale price of the computer and technical support, $300 should be allocated to the sale of the computer and $120 should be allocated to the supply of technical support.

Step 5 – Recognise revenue when (or as) a performance obligation is satisfied

Revenue is recognised either at a point in time, or over a period of time.

The performance obligation to sell a computer is a performance obligation that is satisfied at a point in time – i.e. on 1 December 20X1. Control of the computer was transferred to the customer on 1 December so the revenue of $300 can be recognised on that date.

The performance obligation to supply technical support is recognised over a period of time – i.e. for 12 months commencing 1 December 20X1. In the year ended 31 March 20X2, revenue of $40 (4/12 × $120) should be recognised from the provision of technical support.

As the customer paid $420 immediately, the total recognised as revenue for the year ended 31 March 20X2 is $340 ($300 + $40), leaving deferred income of $80 (included within current liabilities as at 31 March 20X2).

Recognition of revenue – further detail

Revenue is recognised either at a point in time or over a period of time (IFRS 15, para 32).

According to IFRS 15, an entity satisfies a performance obligation and **recognises revenue over time,** if any one of the following criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs its obligations, or

(b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced, or

(c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

This is more likely to apply to the provision of services over a period of time.

If revenue is not recognised over time, then it must be recognised at a point in time (IFRS 15, para 38).

According to IFRS 15, if revenue is to be **recognised at a point in time,** an entity must be able to determine when control over goods or assets supplied has been transferred.

Control of an asset refers to the ability to direct the use of, and obtain substantially all of the remaining benefits (inflows or savings in outflows) from the asset. Control includes the ability to prevent other entities from obtaining benefits (i.e. using or selling) that asset.

The following are indicators of the transfer of control:

- the entity has a present right to payment for the asset
- the customer has legal title to the asset
- the entity has transferred physical possession of the asset
- the customer has the significant risks and rewards of ownership of the asset
- the customer has accepted the asset.

This is more likely to apply when physical products or goods have been sold to a customer and it can be clearly established that control has been transferred at a specific point or date in time.

IFRS 15 Disclosure requirements

Disclosure requirements in the financial statements

According to IFRS 15 Revenue from Contracts with Customers, the following are the key disclosure requirements relating to revenue recognition:

- the accounting policy for revenue recognition should be disclosed.
- significant judgements made to apply the 5-step approach required by IFRS 15 should be disclosed.
- the total amount of revenue recognised, broken down into significant categories should be disclosed.

Test your understanding 4

During the year ended 30 June 20X4, AMS Co entered into the following transactions:

AMS Co agreed to sell goods to Customer A. The goods were delivered on 20 June 20X4 at a price of $1,000 plus sales tax of 20%. The cash was received from Customer A on 31 July 20X4.

AMS Co agreed to sell goods plus a 6-month maintenance agreement to Customer B at a total price of $1,500. If the goods and maintenance contract were sold separately, they would be sold for $900 and $600 respectively. The goods were supplied on 1 May 20X4, and the maintenance contract commenced on that day. Customer B paid the total amount due, plus 20% sales tax, on 15 July 20X4.

AMS Co acted as an agent on behalf of another entity to arrange the sale of goods to Customer C. The goods were delivered to Customer C on 25 June 20X4 at a total price of $600, inclusive of sales tax of 20%. AMS Co is entitled to 10% commission on the sales price as soon as the goods are delivered.

Required:

(a) **How much revenue can AMS Co recognise in its financial statements for the year ended 30 June 20X4 in relation to the transaction with Customer A?**

$________

(b) **What was the amount included within trade receivables at 30 June 20X4 in relation to the contract with Customer A?**

$________

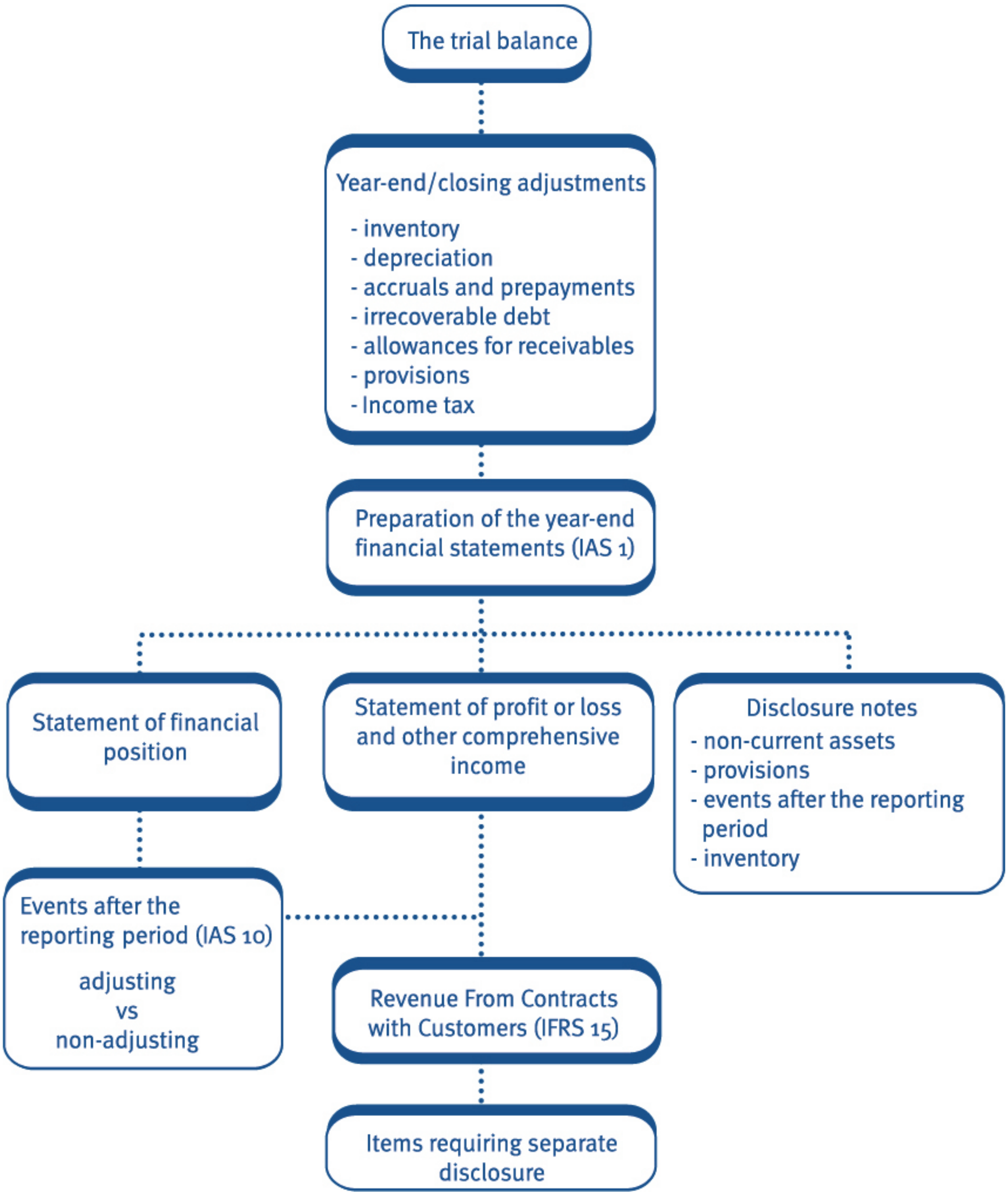
(c) **How much revenue can AMS Co recognise in its financial statements for the year ended 30 June 20X4 in relation to the transaction with Customer B?**

$________

(d) **How much revenue can AMS Co recognise in its financial statements for the year ended 30 June 20X4 in relation to the transaction with Customer C?**

$________

13 Chapter summary



Test your understanding answers

Test your understanding 1

Penguin Co

Statement of profit or loss and other comprehensive income for the year ended 31 December 20X5

	$
Revenue	50,000
Cost of sales (8,000 + 20,000 – 12,000)	(16,000)
Gross profit	34,000
Distribution costs	(8,000)
Administrative expenses	(15,550)
Operating profit	10,450
Fundamental reorganisation costs	(2,400)
	8,050
Finance charges	(800)
Profit before taxation	7,250
Taxation (3,000 – 500)	(2,500)
Profit for the year	4,750
Other Comprehensive Income	
Items that will not be reclassified to profit or loss in future periods:	
Revaluation surplus in the year	6,000
Total Comprehensive Income	10,750

Statement of financial position at 31 December 20X5

	$	$
Non-current assets		
Tangible assets (35,000 + 6,000)		41,000
Current assets		
Inventory	12,000	
Trade receivables	10,000	
Cash at bank and in hand	7,250	
		29,250
Total assets		70,250
Equity		
Ordinary share capital (8,000 + 2,000)		10,000
10% irredeemable preference share capital		9,000
Share premium account (3,000 + 6,000)		9,000
Revaluation surplus		6,000
Retained earnings		5,250
		39,250
Non-current liabilities		
10% loan notes		8,000
Current liabilities		
Trade payables	20,000	
Taxation	3,000	
		23,000
		70,250

Statement of changes in equity for the year ended 31 December 20X5

	Ordinary Share capital	Irredeemable pref capital	Share premium	Revaluation surplus	Retained earnings	Total
	$	$	$	$	$	$
Balance at 1 Jan 20X5	8,000	9,000	3,000	–	3,000	23,000
Revaluation of building				6,000		6,000
Profit for the year					4,750	4,750
Dividends (900 + 1,600)					(2,500)	(2,500)
Issue of share capital*	2,000		6,000			8,000
	–––––	–––––	–––––	–––––	–––––	–––––
Balance at 31 Dec 20X5	10,000	9,000	9,000	6,000	5,250	39,250
	–––––	–––––	–––––	–––––	–––––	–––––

* The issue of 4,000 shares for $8,000 means that they were issued at $2 each. If the nominal value is $0.50 then the premium per share was $1.50. Therefore the increase in share capital was 4,000 shares × $0.50 = $2,000 and the increase in share premium was 4,000 shares × $1.50 = $6,000.

Note that the irredeemable preference share capital has been recognised and classified as equity in both the SOFP and SOCIE. There is no obligation to redeem or repay this share capital – therefore, it is classified as equity.

Test your understanding 2

Ali Page

Statement of profit or loss for the year ended 30 June 20X7

	$
Revenue	120,000
Cost of sales (W1)	(70,000)
Gross profit	50,000
Distribution costs	(13,200)
Administrative and selling expenses (W2)	(15,650)
Operating profit	21,150
Finance costs (W3)	(600)
Profit for the year	20,550

Statement of financial position at 30 June 20X7

	$	$
Non-current assets		87,500
Tangible assets (102,500 – 10,000 – 5,000)		
Current assets		
Inventory	12,000	
Trade receivables (12,200 – 1,000)	11,200	
		23,200
Total assets		110,700
Capital account		
Balance brought forward at 1 July 20X6		73,100
Capital introduced in the year		5,000
Profit for the year		20,550
Drawings		(8,000)
		90,650

Non-current liabilities		
6% bank loan		10,000
Current liabilities		
Trade payables	5,600	
Bank overdraft	4,150	
Interest accrual	300	
		10,050
		110,700

Workings

(W1) Cost of sales

	$
Opening inventory	10,000
Purchases	60,000
Closing inventory	(12,000)
Wages (50% × 15,000)	7,500
Loss on disposal of non-current asset (10,000 – 8,000 proceeds)	2,000
Depreciation charge	5,000
Discount received	(2,500)
	70,000

(W2) Administrative and selling expenses

	$
Per trial balance	5,600
Wages (50% × $15,000)	7,500
Irrecoverable debts written off ($1,550 + $1,000)	2,550
	15,650

(W3) Loan interest

	$
Charge for the year: $10,000 × 6%	600
Amount paid per trial balance	(300)
Accrual required	300

Test your understanding 3

The correct answer is A

1	Sales of year-end inventory at less than cost	Adjusting	Closing inventory must be valued at the lower of cost and net realisable value. The post-yearend sale provides evidence of the net realisable value. Therefore closing inventory must be adjusted to reflect the reduction in value.
2	Share issue	Non-adjusting	
3	Fire in warehouse	Non-adjusting	If only a small quantity of inventory has been destroyed, this will not affect the presumption that the entity is operating as a going concern. However, if the loss of inventory was so pervasive that it affected that ability of the entity to operate as a going concern, this would necessitate a change in the basis of accounting o prepare financial statements on a break-up basis.
4	Bankruptcy of Major customer	Adjusting	The bankruptcy of the customer provides evidence of their inability to pay their debt at the year-end. The amount outstanding from the customer at 30 June 20X6 should therefore be written off in the year-end accounts.
5	Acquisition of Teeny Co	Non-adjusting	
6	Receipt of Insurance monies	Adjusting	The receipt of insurance monies provides evidence of a year-end asset. The amount subsequently received should be reflected as such in the year-end accounts.

Test your understanding 4

(a) **$1,000**

Revenue of $1,000 recognised at a point in time when control was transferred on 20 June 20X4. Remember that revenue excludes sales tax.

(b) **$1,200**

Remember that trade receivables should include sales tax charged as that is the total amount due from the customer. This is outstanding as at 30 June 20X4.

(c) **$1,100**

Revenue of $900 on the supply of goods can be recognised at a point in time when control of the goods has been transferred i.e. on 1 May 20X4.

Revenue on the supply of services should be recognised over a period of time from the date supply commenced i.e. from 1 May 20X4. By 30 June 20X4, 2/6 × $600 = $200 can be recognised.

Therefore, total revenue recognised by 30 June 20X4 re Customer B is $1,100.

(d) **$50**

The net sales value of the transaction, excluding sales tax, is 100/120 × $600 = $500. As the goods were delivered on 25 June 20X4, AMS Co is entitled to commission of 10% × $500 = $50.

Chapter

16

Incomplete records

Chapter learning objectives

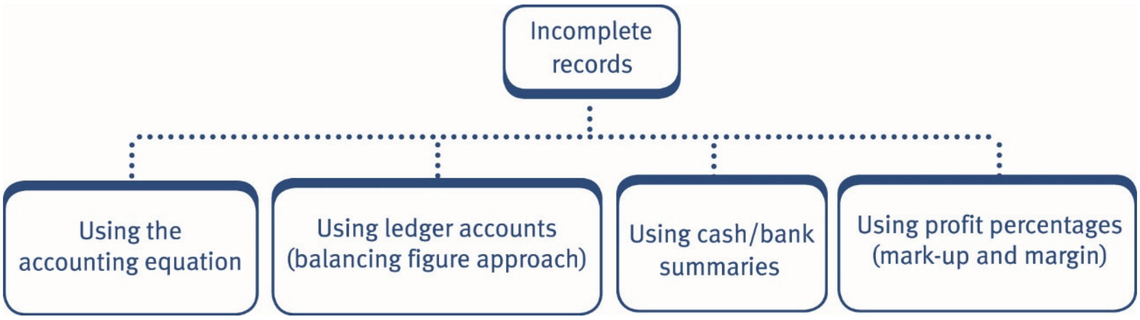
Upon completion of this chapter you will be able to:

- understand and apply techniques used in incomplete record situations:
  - (i) use of the accounting equation
  - (ii) use of ledger accounts to calculate missing figures
  - (iii) use of cash and/or bank summaries
  - (iv) use of given gross profit percentage to calculate missing figures.

PER

One of the PER performance objectives (PO6) is to record and process transactions and events. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter deals with techniques that can be used to derive missing information when the accounting records and ledgers are incomplete or not available for some reason.

The techniques demonstrated in this chapter will be relevant to your future ACCA studies in Financial Reporting.

2 Incomplete records

When you are preparing a set of accounts, it is likely that you may not have all of the information available to you to complete a set of financial statements.

It is possible that you may have incomplete information. If this is the case, you will have to use the best information that is available to you and 'guestimate' any missing figures.

There are a number of different approaches that can be adopted to calculate missing figures and balances, such as:

- accounting equation method
- balancing figure approach
- using cash/banking data, and
- profit ratios – mark-up and margin.

3 Using the accounting equation

If a business entity has recorded very little information of its transactions it may only be possible to calculate net profit for the year. This can be done using the accounting equation as follows:

Assets = equity + liabilities

This can be expanded as follows:

Total assets = share capital + retained earnings + other reserves + total liabilities

We could expand this further to disclose each non-current/current asset and liability. However, that is not necessary as all this represents is the captions from the statement of financial position. The only figure worth expanding is retained earnings (RE):

Closing RE = prior year's RE figure +/– this year's profit(loss) – dividends

By working out the value of closing assets, liabilities and share capital (using a valuation exercise) we should be able to work out the retained earnings figure. If we know the previous year's retained earnings (from last year's statement of financial position) we should be left with the profit/loss for the year as the missing figure.

Test your understanding 1

The statement of Andy Carp Co at 31 December 20X8 shows the following balances:

- Non-current assets – $10,000
- Current assets – $3,400
- Share capital – $200
- Non-current liabilities – $2,100
- Current liabilities – $1,700

The sales, purchases and expense records of Andy Carp Co were unfortunately destroyed and the directors need help to estimate the net profit for the year so that they can estimate its tax liability. The directors have informed you that the retained earnings of the entity at 31 December 20X7 were $7,350.

What was the profit/loss (before tax) made by Andy Carp Co for the year ended 31 December 20X8?

A $2,250

B $2,450

C $2,050

D $9,400

4 The ledger account (balancing figure) approach

The balancing figure approach, using ledger accounts, is commonly used in the following way:

Ledger account	**Possible missing figure**
Receivables	Credit sales, Receipts from credit customers
Payables	Credit purchases, Payments to credit suppliers
Cash at bank	Drawings, Money stolen
Cash in hand	Cash sales, Cash stolen

You may need to distinguish between cash transactions (notes and coins) and transactions which have been recorded in the cash at bank ledger account and, consequently, recorded on the bank statement.

For example, a small-scale retailer such as a newsagent may make a significant proportion of its sales in the form of cash. Some of that cash may be used to pay expenses such as casual wages, cleaning and refreshments, with the balance paid into the bank

Cash at bank ledger account

	$		$
Cash received from customers	X	Cash paid to suppliers	X
Banking from cash in hand	X	Expenses	X
Sundry income	X	Drawings	X
		Money stolen (missing info?)	X
		Balance c/f	X
	X		X
Balance b/f	X		

Cash in hand

	$		$
Cash sales	X	Sundry cash expenses	X
Sundry income	X	Amounts banked	X
		Money lost or stolen	X
		Balance c/f	X
	X		X
Balance b/f	X		

In the case of receivables and payables, you may need to use total receivables or total payables accounts where information presented cannot be allocated between cash and credit transactions as follows:

Total receivables

	$		$
Balance b/f	X	Total receipts in respect of sales (from cash and credit customers)	X
Total sales (cash and credit)	X		
		Balance c/f	X
	——		——
Balance b/f	X		X
	——		——

Total payables

	$		$
		Balance b/f	X
Total payments in respect of purchases (cash purchases and payments to credit suppliers)	X	Total purchases (cash and credit)	X
	——		——
Balance c/f	X	Balance b/f	X
	——		——

Test your understanding 2

Receivables at the start of the accounting period for Rubble's business were $30,000. There were total receipts from customers of $55,000 of which $15,000 related to cash sales and $40,000 related to receipts from receivables. Contras with payables in the year totalled $3,000 and closing receivables were $37,000.

What were total sales for the year?

A $65,000

B $50,000

C $47,000

D $62,000

Test your understanding 3

The opening payables of Dastard-Lee's business were $15,000. Total payments made to suppliers during the year were $14,000. Discounts received were $500 and closing payables were $13,000.

What was the cost of total purchases for the year?

A $16,500

B $18,000

C $12,000

D $12,500

Questions may require you to calculate 'missing' figures from the statement of profit or loss, for example the insurance or rent and rates expense, from information including payments and opening/closing accruals and prepayments.

To calculate the missing value for each expense use either:

- T-accounts, or
- Equations

Test your understanding 4

The following information relates to Lee's business:

On 1 January	Electricity accrued	$250
	Rent prepaid	$300
Cash paid in the year	Electricity	$1,000
	Rent	$2,000
On 31 December	Electricity accrued	$300
	Rent prepaid	$400

What are the charges for electricity and rent in the statement of profit or loss for the year?

	Electricity	**Rent**
	$	$
A	1,050	2,100
B	1,050	1,900
C	950	1,900
D	950	2,100

Test your understanding 5

On 1 January Jude's bank account is overdrawn by $1,367. Payments in the year totalled $8,536 and on 31 December the closing balance is $2,227 (positive).

What were total receipts for the year?

A $4,942

B $7,676

C $9,396

D $12,130

Test your understanding 6

On 1 January, Dale's business had a cash float of $900. During the year cash of $10,000 was banked, $1,000 was paid out as drawings and wages of $2,000 were paid. On 31 December the cash float was $1,000.

How much cash was received from customers for the year?

A $12,900

B $14,900

C $13,100

D $6,900

5 Using cash/bank summaries

The use of bank summaries is similar to the ledger account approach. This method assumes that, whilst data may be missing from the ledger accounts, an entity can always reconstruct its cash inflows and outflows using other information such as bank pay-in in slips or bank statements, or both.

Illustration 1

During the year ended 31 July 20X9 Collins Co lost some of its accounting data due to a computer virus. Whilst it managed to reconstruct elements of its financial statements it needs some help determine sales revenue for the year.

The closing trade receivables figure at 31 July 20X8, taken from the prior year's statement of financial position, was $98,425. You have reviewed the list of receivables (the memorandum accounts) and calculated that the receivables outstanding at 31 July 20X9 total $107,550. After discussions with management you also determine that shortly prior to the year-end $1,500 of trade receivables were written off as irrecoverable.

This has not been reflected in the list of balances/memoranda. To assist you, one of your bookkeepers has performed a bank reconciliation for the year and has calculated that $245,675 was received from customers during the year. Cash till receipts confirm that $53,435 was received during the year from cash sales. The remainder constitutes receipts from credit customers.

What was revenue for Collins Co for the year ended 31 July 20X9?

$............................

Solution to Illustration 1

This, at first, may seem like a daunting question. It is no more difficult than any other question about ledger accounts but it does involve a number of calculations that must be performed to obtain the correct answer. It is therefore important to identify which figures you need to calculate to be able to arrive at the answer.

In this case we need to determine the total sales of Collins Co for the year. This includes both cash and credit sales. We already know the total cash sales – they are $53,435. We therefore need to determine credit sales.

To do this we can use a receivables' account:

Receivables

	$		$
Bal b/f at 1 Aug 20X8			
Credit sales for year		Cash received from credit customers	
		Bal c/f at 31 July 20X9	
	____		____
	____		____

To be able to complete the Receivables account we need four figures:

1 Receivables at 1 August 20X8.

2 Cash received from credit customers.

3 Receivables at 31 July 20X9, and

4 Credit sales for the year.

Let's now work through each of these figures in turn:

1 Receivables at 1 August 20X8 (opening receivables) will be the same as last year's closing figure of $98,425.

2 If total cash received during the year was $245,675 of which $53,435 relates to cash sales. The remaining receipts of $192,240 ($245,675 – $53,435) relate to receipts from credit customers.

3 Closing receivables per the list/memorandum were $107,550. Of this, $1,500 needs to be accounted for as an irrecoverable debt. Therefore the closing receivables figure is $106,050.

4 Credit sales can now be worked out by completing the working as follows:

Receivables

	$		$
B/f at 1 Aug 20X8	98,425	Irrecoverable debt	1,500
Credit sales for year (bal. fig)	201,365	Cash received from credit customers	192,240
		Bal c/f at 31 July 20X9	106,050
	299,790		299,790

Therefore the correct answer for revenue earned is as follows:

	$
Cash sales	53,435
Credit sales	201,365
Revenue	**254,800**

6 Ratios – Mark-up and margin

Gross profit can be expressed as a percentage of either sales or cost of sales:

GROSS PROFIT MARGIN

$$= \frac{\text{Gross profit}}{\text{Sales}} \times 100$$

Therefore

Gross profit = margin% x sales

MARK-UP

$$= \frac{\text{Gross profit}}{\text{Cost of sales}} \times 100$$

Therefore

Gross profit = mark-up% x CofS

For example:

Sales	$5,000
Cost of sales	($4,000)
Gross profit	$1,000

- Gross profit margin = (1,000/5,000) × 100 = 20%
- Mark-up = (1,000/4,000) × 100 = 25%

Test your understanding 7

Pat had sales of $1,000, on which a margin of 25% was made.

What was the cost of sales figure?

A $200

B $800

C $750

D $250.

Test your understanding 8

Ratios

Lazim McDuff had cost of sales of $600. Lazim applied a mark-up of 25% when selling goods.

What was the related revenue?

A $750

B $800

C $250

D $200

Using margin and mark up

Exam questions will often provide you with information about gross profit figures and ratios. You will then be required to calculate a missing figure. This can be done using the following 'relationship' columns:

(**Note:** Sales of $5,000 have been used in both examples to illustrate the difference between mark-up and margin.)

Margin

	$	**Ratio**
Sales	5,000	100%
Cost of sales	4,000	80%
Gross profit	1,000	20%

Mark up

	$	**Ratio**
Sales	5,000	125%
Cost of sales	(4,000)	100%
Gross profit	1,000	25%

If either the mark-up or margin percentage and one of either sales, or cost of sales or gross profit is known, it should be possible to calculate the remaining figures.

Test your understanding 9

Jital Longhorn provides you with the following information:

Margin 5%

Opening inventory $800

Closing inventory $600

Purchases $2,840

Based upon the available information, calculate Jital's sales revenue and gross profit.

Missing inventory figures

Traditionally (before the adoption of computerised accounting systems) many entities did not keep a detailed accounting record of inventories. Such entities would keep records of quantities but, given the proliferation of raw materials, would not complicate matters by keeping accounting records of costs and valuations. Instead, entities would perform a year-end reconciliation of inventory valuations using the principles discussed earlier in this publication.

It is also possible to use the methods described in this chapter to calculate the value of inventory. Remember that cost of sales is equal (in simple terms) to opening inventory + purchases – closing inventory. We have just illustrated how to work out cost of sales using margins and mark ups. The use of ledger accounts and cash records can be used to reconstruct total purchases for the year. In combination these methods can be used to identify the value of either opening or closing inventory.

Test your understanding 10

Joginder Spratt's business suffered a fire during the year. Joginder provided the following information relating to the business operations:

Margin	20%
Sales	$100,000
Opening inventory	$10,000
Purchases	$82,000
Closing inventory after fire	$3,000

What was the cost of inventory lost in the fire?

A $12,000

B $9,000

C $69,000

D $5,667

Double-entries for inventory and lost inventory

Actual closing inventory is posted by:

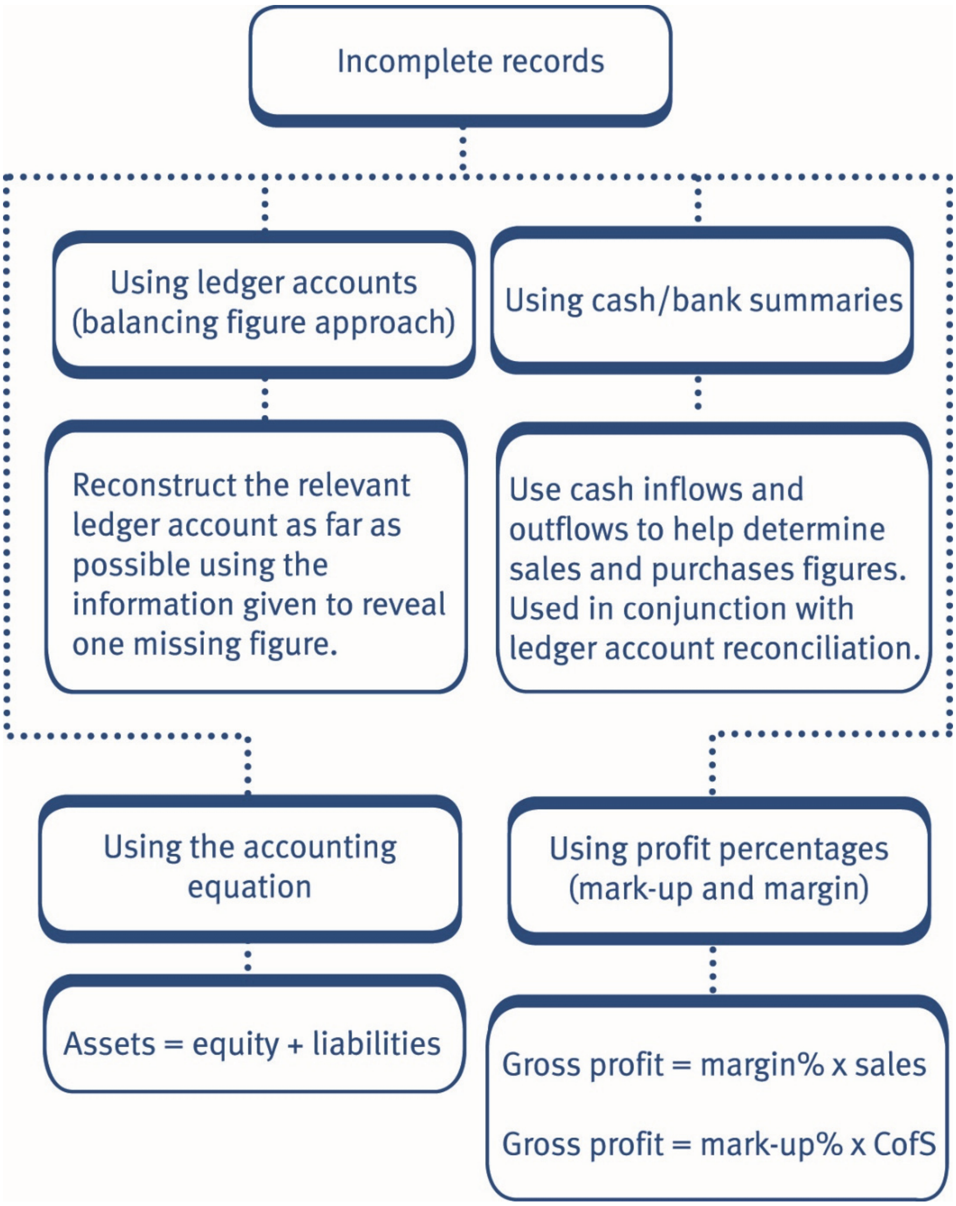
Dr Inventory (SFP)	$X
Cr Profit or loss	$X

Lost inventory will still be credited to the statement of profit or loss so that it is removed from cost of sales. However, the debit side of the entry will depend on whether or not the lost inventory has been insured:

If insured:	Dr Insurance company	$X (Other receivables/current asset)
	Cr Profit or loss	$X (Cost of sales)
If not insured:	Dr Profit or loss	$X (Expense)
	Cr Profit or loss	$X (Cost of sales)

Test your understanding 11
Druva lost all inventory on the premises in a fire. The unsigned business insurance policy (and therefore null and void) is still in Druva's jacket pocket. Druva supplied you with the following information relating to the business: Mark up 25% Sales $10,000 Opening inventory $2,000 Purchases $7,500 **Based upon the available information, calculate the value of inventory destroyed and prepare the journal to record the write-off of inventory.**

7 Chapter summary



Test your understanding answers

Test your understanding 1

The correct answer is C

Total assets = share capital + retained earnings + other reserves + total liabilities

$13,400 = $200 + retained earnings + $3,800

If we re-arrange this formula we end up with:

$13,400 – $200 – $3,800 = retained earnings

Retained earnings = $9,400

Closing retained earnings = prior year retained earnings + current year profits:

$9,400 = $7,350 + current year profits

$9,400 – $7,350 = current year profits

= **$2,050**

Test your understanding 2

The correct answer is A

Receivables

	$		$
Balance b/f	30,000	Bank	40,000
Credit sales (ß)	50,000	Contras with payables	3,000
		Balance c/f	37,000
	80,000		80,000
Balance b/f	37,000		

Receivables

Total sales = credit sales + cash sales = $50,000 + $15,000 = **$65,000**

OR

Total receivables

	$		$
Balance b/f	30,000	Bank (total cash rec'd)	55,000
Total sales (ß)	65,000	Contras with payables	3,000
		Balance c/f	37,000
	95,000		95,000

Test your understanding 3

The correct answer is D

Total payables

	$		$
Bank	14,000	Balance b/f	15,000
Discount received	500	Purchases (ß)	12,500
Balance c/f	13,000		
	27,500		27,500
		Balance b/f	13,000

Test your understanding 4

The correct answer is B

Statement of profit or loss (extracts):

Expenses

Electricity (–250 + 1,000 + 300) = $1,050

Rent (300 + 2,000 – 400) = $1,900

Test your understanding 5

The correct answer is D

Bank

	$		$
Receipts (ß)	12,130	Balance b/f	1,367
		Payments	8,536
		Balance c/f	2,227
	12,130		12,130
Balance b/f	2,227		

Test your understanding 6

The correct answer is C

Cash in till

	$		$
Balance b/f	900	Bank	10,000
Receipts	13,100	Drawings	1,000
		Wages	2,000
		Balance c/f	1,000
	14,000		14,000
Balance c/f	1,000		

Test your understanding 7

The correct answer is C

Gross profit: $1,000 × 25% = $250

Cost of sales:

	$
Sales	1,000
Cost of sales (ß)	(750)
Gross profit	250

Test your understanding 8

The correct answer is A

Gross profit: $600 × 25% = $150

	$
Sales (ß)	750
Cost of sales	(600)
Gross profit	150

Test your understanding 9

	$	$	%
Sales:		3,200	100
Cost of sales:			
Opening inventory	800		
Purchases	2,840		
Closing inventory	(600)		
		(3,040)	(95)
Gross profit:		160	5

Test your understanding 10

The correct answer is B

	$	$	%
Sales:		100,000	100
Cost of sales:			
Opening inventory	10,000		
Purchases	82,000		
Closing inventory	(3,000)		
Inventory lost (ß)	(9,000)		
		(80,000)	(80)
Gross profit:		20,000	20

Test your understanding 11

	$	$	%
Sales:		10,000	125
Cost of sales:			
Opening inventory	2,000		
Purchases	7,500		
Inventory lost (ß)	(1,500)		
		(8,000)	(100)
Gross profit:		2,000	25
Dr Profit or loss (expense):		1,500	
Cr Profit or loss (cost of sales):		1,500	

Being the recording of uninsured inventory destroyed by the fire.

Chapter

17

Statement of cash flows

Chapter learning objectives

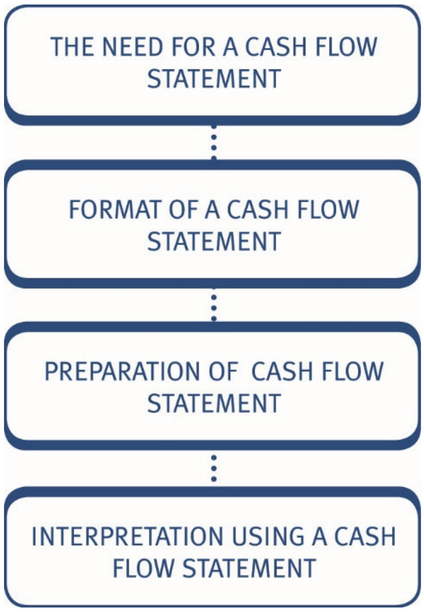
Upon completion of this chapter you will be able to:

- differentiate between profit and cash flows
- recognise the benefits and drawbacks to users of financial statements of a statement of cash flows
- calculate the figures needed for the statement of cash flows
- calculate cash flows from operating activities using the indirect and direct method
- prepare statements of cash flows and/or extracts from given information.

PER

One of the PER performance objectives (PO7) is to prepare and review financial statements in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter deals with the need for a statement of cash flows, along with its preparation and interpretation.

Much of the content of this chapter is new. Preparation and interpretation of a statement of cash flows is examinable content for Financial Reporting and Strategic Business Reporting.

2 The need for a statement of cash flows

Profit and cash

Whilst an entity might be profitable this does not mean it will be able to survive. To achieve this, an entity needs cash to be able to pay its debts. If an entity could not pay its debts it would become insolvent and could not continue to operate.

The main reason for this problem is that profit is not the same as cash flow. Profits (from the statement of profit or loss) are calculated using the accruals basis. Most goods and services are sold on credit so that, at the point of sale, revenue is recognised but no cash is received. The same can be said of purchases made on credit. There are also a number of expenses that are recognised that have no cash impact – depreciation is a good example of this. Therefore, it is possible for an entity to be profitable but have insufficient cash available to pay its short-term liabilities.

For this reason it is important that users of the financial statements can assess the cash position of an entity at the end of the year but also how cash has been generated and used during the accounting period. In the case of limited liability entities, IAS 7 requires that (with very few exceptions) a statement of cash flows is included as part of the annual financial statements that corporate entities make available to shareholders and other users of that information.

Cash flow management

As mentioned above, cash flow is vital to the survival of an entity both in the long and the short term. To reflect this, one of the key measures of the financial health of an entity is solvency or liquidity. These concepts will be discussed at greater length in the interpretations chapter.

In summary, management have various liquid assets at their disposal that they can use to settle the entity's debts in the short term. These include inventory, receivables and cash (i.e. current assets) which are then used to pay off overdrafts, trade payables, loan interest and tax balances (i.e. current liabilities).

Management should maintain sufficient current assets to be able to pay the entity's current liabilities as they fall due. If management do not do this, the entity will default on payment of its liabilities, lose supplier goodwill or suffer fines and sanctions. In the worst case scenario a supplier, lender or tax authority may even have an entity declared insolvent in an attempt to recover amounts due.

To ensure an effective balance, management must consider inventory production and storage cycles and have an effective system of credit control to ensure cash is received as soon as possible. On the flip side it must also manage the level of debt it is exposed to.

IAS 7 Statement of Cash Flows

The objectives of IAS 7 are to ensure that entities:

- report their cash generation and cash absorption for a period by highlighting the significant components of cash flow in a way that facilitates comparison of the cash flow performance of different entities.
- provide information that assists in the assessment of their liquidity, solvency and financial adaptability.

The benefits of a statement of cash flows

A statement of cash flows is needed as a consequence of the differences between profits and cash, as explained earlier. It helps to assess:

- liquidity and solvency – an adequate cash position is essential in the short term both to ensure the survival of the entity and to enable debts and dividends to be paid.
- financial adaptability – will the entity be able to take effective action to alter its cash flows in response to any unexpected events?
- future cash flows – an adequate cash position in the longer term is essential to enable asset replacement, repayment of debt and fund further expansion.

The key point is: cash flow means survival. An entity may be profitable but, if it does not have an adequate cash position, it may not be able to pay its debts, purchase goods for resale, pay its employees etc.

The statement of cash flows also highlights how cash is being generated, i.e. either from operating, financing or investing activities. An entity must be self-sufficient in the long term; in other words, it must generate operating cash inflows or it will be reliant on the sale of assets or further finance to keep it afloat.

Cash flows are also objective; they are matters of fact, whereas the calculation of profit is subjective and possible to manipulate.

The drawbacks of a statement of cash flows

- The statement of cash flows uses historic cash flows (a limitation that can be levied at all components of the financial statements). Users of the accounts are particularly interested in the future.
- No interpretation of the statement of cash flows is provided within the accounts. Users are required to draw their own conclusions as to the relevance of the figures contained within it.
- Non-cash transactions, e.g. bonus issues of shares and revaluations of assets are not highlighted in the statement of cash flows (although they are disclosed elsewhere.

3 Format of a statement of cash flows

IAS 7 Statement of Cash Flows requires entities to prepare a statement of cash flows as part of their annual financial statements. The cash flows must be presented using standard headings. **Note:** There are two methods of reconciling cash from operating activities, which will be discussed later in this chapter.

You should ensure that you understand the items that are included within each of the three sections of the statement of cash flows, together with the reconciliation of the net increase or decrease in cash and equivalents for the year.

Statement of cash flows for the period ended 31 December XXX

	$000	$000
Cash flows from operating activities		
Cash generated from operations (see note below)	X	
Interest paid	(X)	
Income taxes paid	(X)	
Net cash flow from operating activities		X or (X)
Cash flows from investing activities		
Purchase of property, plant and equipment	(X)	
Proceeds of sale of equipment	X	
Interest received	X	
Dividends received	X	
Net cash flow from investing activities		X or (X)
Cash flows from financing activities		
Proceeds of issue of shares	X	
Receipt of new loans	X	
Repayment of loans	(X)	
Dividends paid	(X)	
Net cash flow from financing activities		X or (X)
Net increase (decrease) in cash and cash equivalents		X or (X)
Cash and cash equivalents at the beginning of the period		X or (X)
Cash and cash equivalents at the end of the period		X or (X)

Note re 'Cash generated from operations': This is based upon a reconciliation beginning with profit before tax from the statement of profit or loss which is adjusted for items included in arriving at profit before tax, but which are not reflected by an inflow or outflow of cash. The reconciliation of items from 'Profit before tax' to 'Cash inflow from operating activities' can be shown either on the face of the statement of cash flows itself or as a separate working. This will be explained and illustrated within the chapter.

Definitions

Cash consists of cash in hand and deposits repayable upon demand, less overdrafts.

Cash equivalents are **'short-term, highly liquid investments that are readily convertible to known amounts of cash and are subject to an insignificant risk of changes in value'** (IAS 7, para 6).

Cash flows are **'inflows and outflows of cash and cash equivalents'** (IAS 7, para 6).

Key points

- Operating activities are the principal revenue-producing activities of the entity. This section of the statement begins with profit before tax and is adjusted for various items which have been taken into account in arriving at profit before tax but which do not involve the movement of cash to arrive at 'Cash generated from operations'. This, in turn, is further adjusted to deduct interest paid and tax paid in the year to arrive at 'Net cash flow from operations'. Note that 'Net cash flow from operating activities can be calculated using either the direct or indirect method, and both will be explained and illustrated as the chapter progresses.
- Investing activities are cash spent on non-current assets, proceeds of sale of non-current assets and income from investments.
- Financing activities include the proceeds of issue of shares and long-term borrowings made or repaid.
- Net increase or decrease in cash and cash equivalents is the overall increase (or decrease) in cash and cash equivalents during the year. This can be calculated by comparing the level of cash and cash equivalents included in the statement of financial position at the start and at the end of the accounting period.
- Cash is defined as cash in hand and bank current account balances, including overdrafts.
- Cash equivalents are defined as current asset investments (short-term, highly liquid investments, e.g. a 30 day bond).

4 Cash generated from operations

There are two methods of presenting cash flows from operations. You need to understand both methods of presentation and be able to apply either method in the examination if required.

The direct method provides more detailed information and is based upon cash flow information extracted directly from the accounting records. As this method discloses information that would otherwise remain confidential, most entities do not use the direct method.

Example using the direct method

Example of calculations using direct method

The gross cash flows necessary for the direct method can be derived:

1 from the accounting records of the entity by totalling the cash receipts and payments directly, or

2 from the opening and closing statements of financial position and statement of profit or loss for the year by constructing summary account workings for:

- sales (to derive cash received from customers)
- purchases (to derive cash payments to suppliers)
- wages (to derive cash paid to and on behalf of employees).

Example using ledger accounting information

The statements of financial position of Cash Co were as follows:

	20X7	**20X6**
	$	$
Non-current assets	149,364	153,364
Inventories		
Receivables	346,000	265,840
Cash	165,166	
	660,530	419,204

	20X7	20X6
	$	$
Share capital	200,000	200,000
Reserves	141,640	
	341,640	200,000
Current liabilities	318,890	219,204
	660,530	419,204

Extracts from the statement of profit or loss for the year ended 31 December 20X7:

	$	$
Revenue		1,589,447
Cost of sales:		
Purchases (no inventory)	1,105,830	
Wages and salaries	145,900	
		(1,251,730)
Administration:		
Operating costs	96,077	
Salaries	100,000	
		(196,077)
Operating profit and retained profit for the year		141,640

Additional information

1 Current liabilities consist of

	20X7	20X6
	$	$
Re non-current assets	46,000	
Trade and other payables	258,240	210,564
Wages accrued	14,650	8,640

2 Purchase invoices relating to the acquisition of non-current assets totalling $80,000 have been posted to the payables ledger during the year

Calculate the net cash flow from operating activities using the direct method for the year ended 31 December 20X7.

Solution

	$
Operating activities	
Cash received from customers (W1)	1,509,287
Cash payments to suppliers (W2)	(1,154,231)
Cash paid to and on behalf of employees (W3)	(239,890)
Net cash inflow from operating activities	115,166

Workings

(W1) Receivables' ledger account

	$		$
Balance b/f	265,840	Cash receipts (ß)	1,509,287
Revenue	1,589,447	Balance c/f	346,000
	1,855,287		1,855,287

(W2) Payables' ledger account
(excluding non-current asset purchases)

	$		$
Cash paid (ß)	1,154,231	Balance b/f	210,564
Balance c/f	258,240	Purchases	
		– Cost of sales	1,105,830
		– Operating costs	96,077
	1,412,471		1,412,471

Tutorial note: Information relating to non-current assets is not included in the payables' ledger account above in order to compute cash paid to suppliers of operating costs.

(W3) Wages and salaries

	$		$
Net wages paid (ß)	239,890	Balance b/f	8,640
Balance c/f	14,650	Cost of sales	145,900
		Administration	100,000
	254,540		254,540

Test your understanding 1

The following information relates to Flute, an entity.

Statement of financial position for the year ended 30 September – extracts

	20X8	20X7
	$	$
Trade receivables	31,250	35,633
Trade payables	14,195	13,750
Accrued wages expense	1,015	835
Interest payable	350	300
Income tax payable	1,250	1,075

Statement of profit or loss for the year ended 30 September 20X8 – extracts

	20X8
	$
Sales	427,915
Purchases	165,000
Wages	52,750
Interest expense	325
Income tax charge	1,515

Note: At 30 September 20X8, Flute had agreed to, but not yet accounted for, a contra between trade receivables and trade payables amounting to $230.

Using the indirect method of presentation, prepare the net cash flow from operating activities extract of the statement of cash flows for the year ended 30 September 20X8.

Indirect method

The indirect method of presenting cash flows from operating activities relies upon information that is disclosed in the financial statements, or can be calculated from information disclosed in the financial statements. The starting point is normally profit before tax, which is then adjusted to remove any non-cash items or accruals-based figures included in the statement of profit or loss. The following are examples of adjustments that are normally required when preparing cash flows from operating activities using the indirect method.

- Depreciation – added back to profit before tax because does not result in a cash outflow – it is a non-cash expense.
- Loss or gain on disposal of non-current assets – the loss is a non-cash expense and is added back to profit before tax. The cash proceeds on disposal will be classified as an investing activities cash inflow. Note that a gain on disposal is deducted from profit before tax.
- Interest payable expense – added back to profit before tax because it is not part of cash generated from operations. The cash payment is deducted elsewhere in the statement of cash flows – refer to the proforma statement.
- Increase/decrease in inventory – inventory represents purchases made in one accounting period, but which will be charged against profit in a later accounting period when the goods are sold. An increase in inventory is deducted from profit before tax as it represents a cash outflow to pay for the additional inventory. A decrease in inventory is added to profit before tax as it represents a cash inflow from disposing of inventory during the period under review.
- Increase/decrease in trade receivables – trade receivables represent revenue recognised in profit or loss in one accounting period, whilst the cash will be received in the following accounting period. A decrease in receivables is added to profit before tax as it represents a cash inflow as more cash has been collected from receivables. An increase in trade receivables is therefore deducted from profit before tax
- Increase/decrease in trade payables – trade payables represent purchases made in one accounting period which will be paid for in the following accounting period. An increase in trade payables means that the entity has had the use or benefit of goods and services provided, but not yet paid for them. As such, it preserves cash resources within the entity and is added back to profit before tax. A decrease in trade payables indicates that more payables have been paid off, and will therefore be deducted from profit before tax as a cash outflow.

In order to prepare a statement of cash flows, information from the current and prior year statement of financial position together with the current year statement of profit or loss is used.

The following financial statements provide the source data for the requirements of Test your understanding questions 2–7 inclusive within this chapter.

Test your understanding 2

Statement of financial position of Geronimo at 31 December

	20X6	**20X5**
	$000	$000
Non-current assets	1,048	750
Accumulated depreciation	(190)	(120)
	858	630
Current assets		
Inventory	98	105
Trade receivables	102	86
Dividend receivable	57	50
Cash at Bank	42	18
	299	259
Total assets	1,157	889
Equity and liabilities:		
Share capital	200	120
Share premium	106	80
Revaluation surplus	212	12
Retained earnings	283	226
	801	438
Non-current liabilities:		
Loan	200	300
Current liabilities:		
Trade payables	77	79
Interest accrual	3	5
Tax payable	76	67
	156	151
Total equity and liabilities	1,157	889

Statement of profit or loss for of Geronimo for the year ended 31 December 20X6

	$000
Sales revenue	1,100
Cost of sales	(678)
Gross profit	422
Operating expenses	(309)
Operating profit	113
Investment income	
– interest	15
– dividends	57
Finance charge	(22)
Income tax	(71)
Net profit for year	92

- Operating expenses include a loss on disposal of non-current assets of $5,000.
- During the year an item of plant was disposed of. The plant originally cost $80,000 and had accumulated depreciation to the date of disposal of $15,000.

Calculate the cash flow generated from operations using the indirect method.

5 Cash flows from operating activities

Cash flows may include:

- interest paid
- income taxes paid.

Calculation of interest/income taxes paid

The cash flow should be calculated by reference to:

- the charge to profits for the item (as shown in the statement of profit or loss); and
- any opening or closing payable balance shown on the statement of financial position.

A T-account working may be useful:

e.g. Interest/tax payable account

	$		$
		Accrual b/f	X
Cash paid (ß)	X	P&L charge	X
Accrual c/f	X		
	X		X

The opening and closing accruals are taken from the relevant statement of financial position. The expense for the year is taken from the statement of profit or loss. The missing figure will therefore be the cash paid in the year.

Test your understanding 3
Identify and calculate the cash flows relating to interest paid and income tax paid for inclusion under the heading 'Cash flows from operating activities' within Geronimo's statement of cash flows.

6 Cash flows from investing activities

Cash flows from investing activities may include:

- interest received
- dividends received
- proceeds of disposal of non-current assets.

Cash outflows may include:

- purchase of property, plant and equipment.

Interest received and dividends received are normally classified as investing activities cash inflows. However, IAS 7 does permit interest received and dividends received to be classified as operating activities. This is perhaps most appropriate for financial institutions who generate interest earnings and dividend receipts as part of their normal operations, although this classification could be adopted by any entity. The important point to remember is that, whichever classification is adopted by an entity, it is applied consistently from one accounting period to another.

Calculation of interest and dividends received

Again, the calculation should take account of both the income shown in the statement of profit or loss and any relevant receivables balance from the opening and closing statements of financial position.

A T-account working may be useful:

e.g. Interest receivable

	$		$
Interest receivable b/f	X		
P/L interest receivable	X	Cash received (ß)	X
		Interest receivable c/f	X
	X		X

Test your understanding 4

Identify and calculate the dividends and interest received to be shown under the heading 'Cash flows from investing activities' within Geronimo's statement of cash flows.

Calculation of purchase of property, plant and equipment and proceeds of sale of equipment

These cash flows are often the trickiest to calculate within a statement of cash flows. It is therefore recommended that T-account workings are used.

The following T-accounts will be required for each class of asset:

- cost account
- accumulated depreciation account
- disposals account (where relevant).

Data provided in the source financial statements should then be entered into these T-accounts and the required cash flows found – often as balancing figures.

Note: If there is evidence of a revaluation, remember to include the uplift in value on the debit side of the asset T-account.

In some cases, insufficient detail is provided to produce separate asset and accumulated depreciation accounts. Instead, a carrying amount T-account working should be used:

NCA – carrying amount

	$		$
Carrying amount b/f	X		
Additions at carrying amount (= cash paid to purchase PPE)	X	Disposals at carrying amount	X
Revaluation in year	X	Depreciation charge for year	X
		Carrying amount c/f	X
	X		X

Test your understanding 5

Identify and calculate the cash outflow to purchase property, plant and equipment and the proceeds from the sale of equipment to be shown under the heading 'Cash flows from investing activities' within Geronimo's statement of cash flows.

7 Cash flows from financing activities

Cash inflows from financing activities may include:

- proceeds of the issue of shares
- proceeds of receipt of loans/debentures.

Cash outflows may include:

- repayment of loans/debentures
- dividends paid
- interest paid.

Note that IAS 7 permits interest paid to be classified as a cash outflow within either operating activities or as a financing activity. The important point is to ensure that the cash outflow for interest paid in the year is classified either within operating activities or within financing activities and not included twice within the statement of cash flows.

Calculation of the proceeds from a share issue is derived by comparison of the balances included in the statement of financial position brought forward and carried forward on two accounts:

- share capital, and
- share premium.

Note that, if there is a bonus issue made in the year, this will not result in a cash inflow but will need to be included in the workings to ensure that share capital movements in the year are correctly stated.

Calculation of the proceeds or repayment of a loan

This cash flow is derived by comparing the brought forward balance with the balance carried forward. A fall in the amount outstanding indicates that all or part of the loan has been repaid in the year (a cash outflow). An increase indicates that there has been a further loan received during the year (a cash inflow). Note that this is one of the few cash flows that could be either a cash inflow or a cash outflow.

Dividends paid

An entity can only account for dividends paid to its own shareholders on a cash basis in the financial statements. As dividends paid are effectively paid out of retained earnings, it is usually necessary to reconcile the opening and closing balances on retained earnings to identify any dividend paid in the year as a balancing figure.

Note that IAS 7 permits dividends paid to be classified as either an operating cash flow or as a financing cash flow. It is more usual to classify dividends paid as a financing cash flow.

Test your understanding 6
Identify and calculate each of the amounts to be shown under the heading 'Cash flows from financing activities' within Geronimo's statement of cash flows.

Test your understanding 7

Complete the following proforma statement of cash flows for Geronimo using your answers to Test your understanding questions 2–6.

Statement of cash flows for Geronimo for year ended 31 December 20X6

	$000	$000
Cash flows from operating activities		
Cash generated from operations		
Interest paid		
Tax paid		
		–––––
Net cash from operating activities		
Cash flows from investing activities		
Proceeds of sale of equipment		
Purchase of property, plant and equipment		
Interest received		
Dividends received		
	–––––	
Net cash used in investing activities		
Cash flows from financing activities		
Proceeds of issue of shares		
Repayment of loans		
Dividends paid		
	–––––	
Net cash used in financing activities		
Net increase in cash and cash equivalents		
		–––––
Cash and cash equivalents at beginning of period		
		–––––
Cash and cash equivalents at end period		

Test your understanding 8

You are given below, in summarised form, the accounts of Algernon, an entity, for 20X7 and 20X6.

	31 December 20X7			31 December 20X6		
	Cost	**Dep'n**	**CA**	**Cost**	**Dep'n**	**CA**
	$	$	$	$	$	$
Plant	11,000	5,000	6,000	10,000	4,000	6,000
Buildings	90,000	11,000	79,000	50,000	10,000	40,000
			85,000			46,000
Investments at cost			80,000			50,000
Land			63,000			43,000
Inventory			65,000			55,000
Receivables			50,000			40,000
Cash at bank						3,000
			343,000			237,000
Ordinary shares of $1 each			50,000			40,000
Share premium			14,000			12,000
Revaluation surplus (land)			20,000			–
Retained earnings			45,000			45,000
10% Loan notes			150,000			100,000
Payables			60,000			40,000
Bank			4,000			–
			343,000			237,000

Statement of profit or loss for the years ended 31 December:

	20X6	20X7
	$	$
Sales	200,000	200,000
Cost of sales	(120,000)	(100,000)
	80,000	100,000
Expenses	(47,000)	(50,000)
	33,000	50,000
Interest	(13,000)	(10,000)
Net profit for year	20,000	40,000

Notes:

A $20,000 dividend has been paid in the year.

Required:

(a) Prepare a statement of cash flows for Algernon for the year ended 31 December 20X7, to explain as far as possible the movement in the bank balance.

The statement of cash flows should be prepared using the direct method.

(b) Using the summarised accounts given, and the statement just prepared, comment on the financial position, progress and direction of Algernon.

Test your understanding 9

An extract of an entity's statement of cash flows is shown below:

	$000
Profit before tax	1,255
Loss on disposal	(455)
Increase in receivables	(198)
Increase in payables	340

The following criticisms of the extract have been made:

1 The loss on disposal should have been added, not deducted.

2 Increase in receivables should have been added, not deducted.

3 Increase in payables should have been deducted, not added.

Which of the criticisms is valid?

A 1, 2 and 3

B 1 only

C 2 and 3 only

D none of them

Test your understanding 10

Which of the following could appear in an entity's statement of cash flows?

1 Proposed dividend

2 Dividends received

3 Bonus issue of shares

4 Surplus on revaluation of non-current assets

A 1 and 2

B 1,2 and 3

C 2 only

D 2 and 3

Test your understanding 11

The following details were provided by Caddyshack Co which had a profit before tax of $434,850 for the year ended 31 December 20X6.

1 Depreciation of $37,400 was charged to the statement of profit or loss; this included an amount of $7,600 which was the loss on disposal of a non-current asset.

2 Finance costs of $35,000 were charged to the statement of profit or loss.

3 The following extract of the statement of financial position at 31 December 20X6 and 20X5 was provided:

	31 Dec 20X6	**31 Dec 20X5**
	$000	$000
Inventory	145	167
Trade receivables	202	203
Prepayments	27	16
Trade payables	196	212
Interest payable	6	28

What was the cash generated from operations?

A $468,250

B $511,250

C $476,250

D $503,250

8 Chapter summary

The need for a statement of cash flows

- Helps to assess liquidity of a company.
- Helps to assess future cash flows.
- User can see cash flows in and out of the business.

Format of a statement of cash flows

IAS 7 requires the cash flow statement to have three headings:

- Operating activities
- Investing activities
- Financing activities.

Preparation of a statement of cash flows

The cash movement is simply the movement between the current and previous year's balance in the statement of financial position.

Watch out for trickier areas such as taxation, and non-current assets where a working will need to be done.

Interpretation using a statement of cash flows

The cash flow provides useful information including:

- how a business spends and receives cash
- whether operating activities yield a positive cash flow
- whether the business has the ability to generate cash in the future.

Test your understanding answers

Test your understanding 1

Operating activities	$
Cash received from customers (W1)	432,298
Cash payments to suppliers (W2)	(164,555)
Cash paid to and on behalf of employees (W3)	(52,570)
Cash inflow from operations	215,173
Interest paid (W4)	(275)
Income tax paid (W5)	(1,340)
Net cash inflow from operating activities	213,558

Workings

(W1)

Receivables

	$		$
Balance b/f	35,633	Cash receipts (ß)	432,298
		Contra with payables	230
Sales revenue	427,915	Balance c/f (31,250 – 230)	31,020
	463,548		463,548

(W2)

Payables

	$		$
Cash paid (ß)	164,555	Balance b/f	13,750
Contra with receivables	230	Purchases	165,000
Balance c/f (14,195 – 230)	13,965		
	178,750		178,750

(W3) **Wages**

	$		$
Net wages paid (ß)	52,570	Balance b/f	835
Balance c/f	1,015	Profit or loss	52,750
	53,585		53,585

(W4) **Interest payable**

	$		$
Interest paid (ß)	275	Balance b/f	300
Balance c/f	350	Profit or loss	325
	625		625

(W5) **Income tax**

	$		$
Interest paid (ß)	1,340	Balance b/f	1,075
Balance c/f	1,250	Profit or loss	1,515
	2,590		2,590

Note: When the contra is accounted for, it will reduce the balance outstanding at the year-end of both trade receivables and trade payables.

Test your understanding 2

	$000
Profit before tax (92 + 71) (i.e. as per properly formatted P&L)	163
Add: Finance charge per P&L	22
Less: Investment income per P&L	(72)
Add: Depreciation (W1)	85
Add: Loss on disposal of plant	5
Add: Decrease in inventory (105 – 98)	7
Less: Increase in trade receivables (86 – 102)	(16)
Less: Decrease in trade payables (79 – 77)	(2)
Cash flow generated from operations	192

Note that interest paid and income tax paid would need to be deducted to arrive at 'Net cash flow from operations'.

(W1)

Accumulated depreciation

	$000		$000
Disposals	15	Balance b/f	120
Balance c/f	190	Depreciation charge (ß)	85
	205		205

Test your understanding 3

Interest paid

Interest payable

	$000		$000
		Interest accrual b/f	5
Cash paid (ß)	24		
Interest accrual c/f	3	P/L finance charge	22
	27		27

Income tax payable

	$		$
		Tax payable b/f	67
Cash paid (ß)	62	P/L tax charge	71
Tax payable c/f	76		
	138		138

Test your understanding 4

There is no balance for interest receivable at the start or end of the year; therefore interest received must equal interest receivable in the statement of profit or loss.

Interest received $15,000

Dividends received

Dividends receivable

	$		$
Dividends receivable b/f	50	Cash received (ß)	50
P/L dividends receivable	57	Dividends receivable c/f	57
	X		X

Test your understanding 5

PPE cost

	$000		$000
Balance b/f	750		
Additions (= Cash to purchase PPE)	178	Disposals	80
Revaluation (212 – 12)	200	Balance c/f	1,048
	1,128		1,128

Disposals

	$000		$000
Cost	80	Accumulated depreciation	15
		Loss on disposal	5
		Proceeds (ß)	60
	80		80

Test your understanding 6

	20X6	20X5	
	$000	$000	$000
Share capital	200	120	
Share premium	106	80	
	306	200	
Proceeds of share issue			106

Repayment of loan

- Balance on loan account was $300,000 in 20X5; in 20X6 it is $200,000.
- Therefore $100,000 has been repaid.

Dividends paid

Retained earnings

	$000		$000
		Balance b/f	226
Dividends paid (bal. fig)	35	Profit for the year (P/L)	92
Balance c/f	283		
	318		318

Test your understanding 7

Statement of cash flows for Geronimo for year ended 31 December 20X6

	$000	$000
Cash flows from operating activities		
Cash generated from operations (TYU 1)	192	
Interest paid (TYU 2)	(24)	
Tax paid (TYU 2)	(62)	
	———	
Net cash generated from operating activities		106
Cash flows from investing activities		
Proceeds of sale of equipment (TYU 4)	60	
Purchase of property, plant and equipment (TYU 4)	(178)	
Interest received (TYU 3)	15	
Dividends received (TYU 3)	50	
	———	
Net cash used in investing activities		(53)
Cash flows from financing activities		
Proceeds of issue of shares (TYU 5)	106	
Repayment of loans (TYU 5)	(100)	
Dividends paid (TYU 5)	(35)	
	———	
Net cash generated from financing activities		(29)
		———
Net increase in cash and cash equivalents		24
Cash and cash equivalents at beginning of period		18
		———
Cash and cash equivalents at end of period		42
		———

Test your understanding 8

(a) **Statement of cash flows for Algernon for year ended 31 December 20X6**

	$	$
Cash flows from operating activities		
Cash receipts from customers (W1)	190,000	
Cash paid to suppliers and employees (W2)	(155,000)	
Cash generated from operations	35,000	
Interest paid	(13,000)	
Net cash from operating activities		22,000
Cash flows from investing activities		
Purchase of tangible non-current assets (1,000 + 40,000)	(41,000)	
Purchase of investments	(30,000)	
Net cash used for investing activities		(71,000)
Cash flows from financing activities		
Issue of shares (10,000 + 2,000)	12,000	
Loan notes	50,000	
Dividends paid	(20,000)	
Net cash from financing activities		42,000
Net decrease in cash and cash equivalents		(7,000)
Cash and cash equivalents at 1 January 20X7		3,000
Cash and cash equivalents at 31 December 20X7		(4,000)

	31 December	
	20X7	**20X6**
	$	$
Balance at bank	(4,000)	3,000

Workings

(W1) Receipts from sales

Receivables

	$		$
Balance b/f	40,000	Cash receipts (ß)	190,000
Sales revenue	200,000	Balance c/f	50,000
	240,000		240,000

(W2) Payables and wages

Payable and wages

	$		$
Cash paid (ß)	155,000	Balance b/f	40,000
Depreciation	2,000	Purchases re cost of sales (W3)	130,000
Balance c/f	60,000		
		Expenses	47,000
	217,000		217,000

(W3) Cost of sales

Cost of sales

	$		$
Opening inventory	55,000	Cost of sales	120,000
Purchases and wages (ß)	130,000	Closing inventory	65,000
	185,000		185,000

(b) Algernon has invested substantially in buildings, investments, inventory and receivables in the year. The finance has come from new share capital in part but mainly from loans. The equity to assets ratio of the entity has thus decreased. The working capital has been financed by an equal increase in trade payables.

The profits have been fully distributed as dividends despite the halving of profits from last year. It might have been wiser to cut back on dividends in the period of expansion until the benefits of the expansion are seen in the form of higher profits.

Test your understanding 9

The correct answer is B

A loss on disposal should be added back to profit as it is a non-cash expense.

Test your understanding 10

The correct answer is C

Dividends received involve a cash receipt. The other transactions do not involve a movement of cash.

Test your understanding 11

The answer is D

	$
Profit before tax	434,850
Depreciation and loss on disposal charged in P&L	37,400
Decrease in inventory	22,000
Decrease in trade receivables	1,000
Increase in prepayments	(11,000)
Decrease in trade payables	(16,000)
Finance costs charged in P&L	35,000
Cash generated from operations	503,250

Note that the finance costs charged in the statement of profit or loss are included in the reconciliation to identify cash generated from operations. However, the cash paid in the year relating to finance costs is only relevant when calculating the net cash flow from operations.

Chapter

18

Interpretation of financial statements

Chapter learning objectives

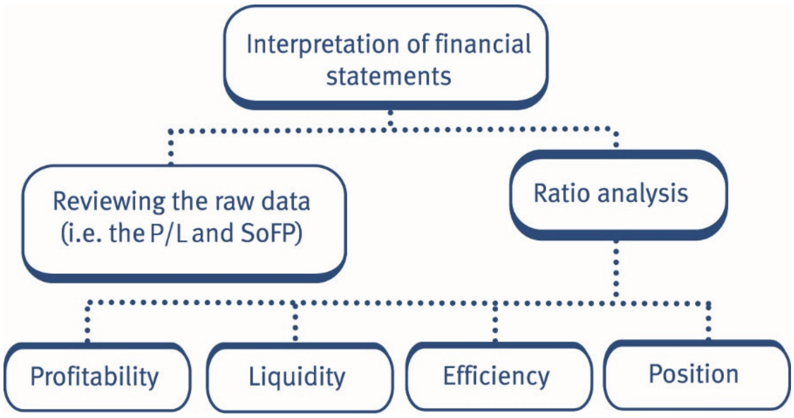
Upon completion of this chapter you will be able to:

- describe how the interpretation and analysis of financial statements is used in a business environment
- explain the purpose of the interpretation of ratios
- calculate and interpret the relationship between the following key accounting ratios
  - profitability
  - liquidity
  - efficiency
  - position
- explain the interrelationships between ratios
- draw valid conclusions from the information contained within the financial statements.

PER

One of the PER performance objectives (PO8) is to analyse financial statements to evaluate and assess the financial performance and position of an entity. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter deals with the interpretation of financial statements. As such, it makes use of much of the content of earlier chapters.

Much of the content of this chapter is new. Interpretation of financial statements is an important topic for Financial Reporting and Strategic Business Reporting.

2 Interpreting financial information

Introduction

Financial statements on their own are of limited use. If you were to identify that a business made a profit before tax of $1 million what does that tell you about the business? Does it suggest the business is a success? It may do, but not if in the previous year it a profit before tax of $50 million and its closest rival generated a profit before tax of $60 million.

It is important that users of financial statements can interpret the financial statements to be able to draw out valid conclusions. Typically this involves the use of comparisons to prior years, forecasts and competitors. Users can compare sales and expense figures, asset and liability balances and cash flows to perform this analysis.

Ratio analysis is widely used to support this process of comparison. Don't forget, though, that ratios are calculated using the figures already present in the financial statements. The raw data is equally useful when performing analysis. Ratios are simply a tool to try and assist understanding and comparison of financial performance and position.

Users of financial statements

When interpreting financial statements it is important to ascertain who the users of accounts are and what information they need:

- shareholders and potential investors – primarily concerned with receiving an adequate return on their investment, but also with the stability/liquidity of the business
- suppliers and lenders – concerned with the security of their debt or loan
- management – concerned with the trend and level of profits, since this is the main measure of their success.

Other potential users include:

- financial institutions
- employees
- professional advisors to investors
- financial journalists and commentators.

3 Ratio analysis

Ratios use simple calculations (usually percentages) based upon the interactions in sets of data. For example, changes in costs of sale are directly linked to changes in sales activity. Changes in sales activity also have an effect upon wages and salaries, receivables, inventory levels etc. Ratios allow us to see those interactions in a simple, concise format.

Ratios are of limited use on their own, thus, the following points should serve as a useful checklist if you need to analyse data and comment on it:

- What does the ratio literally mean?
- What does a change in the ratio mean?
- Is there a norm or benchmark and, if so, what is it?
- What are the limitations of the ratio?

4 Profitability ratios

Gross profit margin

On a unit basis the gross profit represents the difference between the unit sales price and the direct cost per unit. The gross profit margin works this out on an average basis across all sales for the year.

Gross profit margin is calculated as follows:

$$\frac{\text{Gross profit}}{\text{Revenue}} \times 100\%$$

Changes in this ratio may be attributable to:

- selling prices
- product mix
- purchase costs
- production costs
- inventory valuations.

Gross profit margin

Comparing gross profit margin over time

If gross profit has not increased in line with revenue, you need to establish why not. Is the discrepancy due to:

- increased 'purchase' costs: if so, are the costs under the entity's control (i.e. does the entity manufacture the goods sold)?
- inventory write-offs (likely where the entity operates in a volatile marketplace, such as fashion retail)? or
- other costs being allocated to cost of sales – for example, research and development (R&D) expenditure?

Inter-company comparison of gross profit margin

Inter-company comparison of margins can be very useful but it is especially important to compare business entities within the same sector. For example, food retailing is able to support low margins because of the high volume of sales. Jewellers would usually need higher margins to offset lower sales volumes.

Low margins usually suggest poor performance but may be due to expansion costs (launching a new product) or trying to increase market share. Lower margins than usual suggest scope for improvement.

Above-average margins are usually a sign of good management although unusually high margins may make the competition keen to join in and enjoy the 'rich pickings'.

Operating profit margin (net profit)

The **operating profit margin** or net profit margin is calculated as:

$$\frac{\text{PBIT}}{\text{Revenue}} \times 100\%$$

The operating margin is an expansion of the gross margin and includes all of the items that come after gross profit but before finance charges and taxation, such as selling and distribution costs and administration costs.

If the gross margin is a measure of how profitably an entity can produce and sell its products and services the operating margin also measures how effectively the business manages/administers that process.

Therefore, if the gross margin has remained static but the operating margin has changed consider the following possibilities (these represent suggestions; it is not a comprehensive list):

- changes in employment patterns (recruitment, redundancy etc.)
- changes to depreciation due to significant asset acquisitions or disposals
- significant write-offs of irrecoverable debt
- changes in rental agreements
- significant expenditure on advertising
- rapidly changing fuel costs.

Operating profit margin

This is affected by more factors than the gross profit margin but it is equally useful to users and if the entity does not disclose cost of sales it may be used on its own in lieu of the gross profit percentage.

One of the many factors affecting the trading profit margin is depreciation, which is open to considerable subjective judgement. Inter-company comparisons should be made after suitable adjustments have been made to align accounting policies.

By the time you have reached operating (net) profit, there are many more factors to consider. If you are provided with a breakdown of expenses you can use this for further line-by-line comparisons. Bear in mind that:

- some costs are fixed or semi-fixed (e.g. property costs) and therefore not expected to change in line with revenue
- other costs are variable (e.g. packing and distribution, and commission).

Return on capital employed (ROCE)

This is an important analysis tool as it allows users to assess how much profit the business generates from the capital invested in it. Profit margins of different entities are not necessarily comparable due to different sizes and business structures. You could have one entity that makes large profits but based on huge levels of investment. Shareholders may decide that they can make similar returns in different entities without such a high initial investment required.

In simple terms ROCE measures how much operating profit is generated for every $1 capital invested in the business.

$$\textbf{ROCE} = \frac{\text{Operating profit}}{\text{Capital employed}} \times 100\%$$

Capital employed can be measured in either of the two following ways:

- equity, plus interest-bearing finance, i.e. non-current loans plus share capital and reserves or
- total assets less current liabilities.

Note that either method will provide the same end answer to calculate capital employed.

ROCE

When calculated, ROCE should be compared with:

- previous years' figures – provided there have been no changes in accounting policies, or suitable adjustments have been made to facilitate comparison (note, however that the effect of not replacing non-current assets is that their value will decrease and ROCE will increase)
- the entity's target ROCE – where the entity's management has determined a target return as part of its budget procedure, consistent failure by a part of the business to meet the target may make it a target for disposal
- other entities in same industry – care is required in interpretation, because of the possibility, noted above, of different accounting policies, ages of non-current assets, etc.

The ratio also shows how efficiently a business is using its resources. If the return is very low, the business may be better off realising its assets and investing the proceeds in a high interest bank account! (This may sound extreme, but should be considered particularly for a small, unprofitable business with valuable assets such as property.) Furthermore, a low return can easily become a loss if the business suffers a downturn.

5 Net asset turnover

Net asset turnover

The **net asset turnover** is:

$$\frac{\text{Revenue}}{\text{Capital employed (net assets)}} = \text{times pa}$$

This ratio measures management's efficiency in generating revenue from the net assets at its disposal. This is similar to ROCE but in this case it measures the amount of revenue generated for every $1 capital invested in the business. Generally speaking, the higher the ratio the more efficient the business is.

Further explanation of net asset turnover

Note that this can be further subdivided into:

- non-current asset turnover (by making non-current assets the denominator) and
- working capital turnover (by making net current assets the denominator).

Be aware that both ROCE and asset turnover can be significantly affected by a change in the business structure. For example, consider that a manufacturing entity buys a significant amount of property and plant in a particular year with the aim to increase production and, therefore, revenue. The short term effect is that ROCE and asset turnover will initially fall but this does not mean the business is actually performing any worse. It may even be an indication of future gains.

The reason is that the capital balance (net assets) will increase in comparison to the steady sales figures of the business. It cannot be expected that a business can buy new assets and simply grow immediately. It may take a number of years for a business to grow into its new assets and increase production until it operated at 100% capacity. Even if it could instantly use 100% of the new facilities, it is unlikely that it will simply be able to sell all the new goods produced instantly. The business will need to find new customers, perhaps in new markets to be able to sell its goods. Of course, this does not take into account competitor responses!

In summary, the increase in capital would be both significant and instant. The consequent improvement in performance would normally take longer to achieve and would most likely be spread over a number of years. Both ROCE and asset turnover would fall instantly and then start to improve each year as revenues start to grow.

Relationship between ratios

ROCE can be subdivided into operating profit margin and asset turnover.

$$\text{Operating margin} \times \text{asset turnover} = \text{ROCE}$$

$$\frac{\text{Operating profit}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Capital employed}} = \frac{\text{Operating profit}}{\text{Capital employed}}$$

Further explanation of the relationship

Profit margin is often seen as an indication of the quality of products or services supplied (top-of-range products usually have higher margins).

Asset turnover is often seen as a measure of how intensively the assets are worked or how efficiently they are used to generate revenue.

A trade-off often exists between margin and asset turnover that means different businesses can actually achieve the same ROCE:

- Low-margin businesses (e.g. food retailers) often have intensive asset usage (i.e. they produce a high volume of goods to sell but sell them at low prices and margins).
- Higher margin businesses (e.g. luxury jewellery items) produce a lower volume of products but sell them at a high price. Many of these businesses still use very labour intensive, rather than machine intensive, methods of production. Such crafts are highly valued and consumers are willing to pay a premium for them.

6 Liquidity and Efficiency ratios

These ratios assess the liquidity/solvency of a business (i.e. the ability to meet debt obligations) and how efficiently the entity manages its working capital resources.

Current ratio

Current or working capital ratio:

$$\frac{\text{Current assets}}{\text{Current liabilities}} : 1$$

The current ratio measures the adequacy of current assets to meet liabilities as they fall due.

A high or increasing figure may appear safe but should be regarded with caution as it may be due to:

- high levels of inventory and receivables (this could mean inventory is unsaleable or that credit control is weak)
- high cash levels which could be put to better use (e.g. by investing in non-current assets).

Current ratio

The current ratio measures the adequacy of current assets to meet the entity's short-term liabilities. It reflects whether the entity is in a position to meet its liabilities as they fall due.

Traditionally, a current ratio of 2:1 or higher was regarded as appropriate for most business entities to maintain creditworthiness. However, more recently a figure of 1.5:1 is regarded as the norm, although this is subject to much variation.

The current ratio should, however, be considered in the context of what is normal for a particular business entity, or the industry it operates in. For example, supermarkets tend to have a low current ratio because:

- there are few trade receivables
- there is a high level of trade payables
- there is usually very tight cash control, to fund investment in developing new sites and improving sites.

It is also worth considering:

- availability of further finance, e.g. is the overdraft at the limit? – very often this information is highly relevant but is not disclosed in the accounts
- seasonal nature of the business – one way of doing this is to compare the interest charges in the statement of profit or loss with the overdraft and other loans in the statement of financial position; if the interest rate appears abnormally high, this is probably because the entity has had higher levels of borrowings during the year
- long-term liabilities, when they fall due and how will they be financed
- nature of the inventory – where inventories are slow moving, the quick ratio probably provides a better indicator of short-term liquidity.

Quick ratio

Quick ratio (also known as the acid test) ratio:

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}} : 1$$

The quick ratio is also known as the acid test ratio because by eliminating inventory from current assets it provides the acid test of whether the entity has sufficient liquid resources (receivables and cash) to settle its liabilities as they fall due.

Quick ratio

Normal levels for the quick ratio range from 1:1 to 0.7:1.

Similar to the current ratio, it is relevant to consider the nature of the business (again, supermarkets have very low quick ratios).

Sometimes the **quick ratio** is calculated on the basis of a six-week time-frame (i.e. the quick assets are those which will turn into cash in six weeks; quick liabilities are those which fall due for payment within six weeks). This basis would usually include the following in **quick assets**:

- bank, cash and short-term investments
- trade receivables.

thus excluding prepayments and inventory.

Quick liabilities would usually include:

- bank overdraft which is repayable on demand
- trade payables, tax and social security dividends.

Income tax liabilities may be excluded.

When interpreting the quick ratio, care should be taken over the status of the **bank overdraft.** An entity with a low quick ratio may actually have no problem in paying its amounts due if sufficient overdraft facilities are available.

Inventory turnover period

Inventory turnover period is defined as:

$$\frac{\text{Inventory}}{\text{COS}} \times 365 = \text{X days}$$

This simply measures how efficiently management uses its inventory to produce and sell goods.

An increasing number of days implies that management are holding inventory for longer time periods. This could indicate lack of demand or poor inventory control.

Alternatively, the increase in inventory holding could be due to:

- buying in bulk to take advantage of trade discounts
- reducing the risk of 'stockouts', or
- an expected increase in orders, perhaps for a seasonal business.

Either way, the consequence is that the costs of storing, handling and insuring inventory levels will also increase. There is also an increased risk of inventory damage and obsolescence.

Alternative

An alternative is to express the inventory turnover period as a number of times:

$$\frac{\text{Cost of sales}}{\text{Inventory}} = \text{times pa}$$

A high turnover indicates that management generally hold quite a low level of inventory in comparison to overall sales. This means their costs of holding inventory are reduced, although the entity may require more frequent deliveries. A just-in-time system would reflect this sort of strategy. A low inventory turnover indicates that management hold on to a high level of inventory in comparison to overall sales levels.

Inventory days – A word of caution

Year-end inventory is normally used in the calculation of inventory turnover. An average (based on the average of year-start and year-end inventories) may be used to have a smoothing effect, although this may dampen the effect of major or seasonal changes during the period.

Inventory turnover ratios vary enormously with the nature of the business. For example, a fishmonger selling fresh fish would have an inventory turnover period of 1–2 days, whereas a building contractor may have an inventory turnover period of 200 days. Manufacturing entities may have an inventory turnover ratio of 60–100 days; this period is likely to increase as the goods made become larger and more complex.

For large and complex items (e.g. rolling stock or aircraft) there may be sharp fluctuations in inventory turnover according to whether delivery took place just before or just after the year end.

A manufacturer should take into consideration:

- the reliability of suppliers: if the supplier is unreliable it is prudent to hold more raw materials
- demand: if demand is erratic it is prudent to hold more finished goods.

Receivables collection period

This is normally expressed as a number of days:

$$\frac{\text{Trade receivables}}{\text{Credit sales}} \times 365 = \text{X days}$$

The ratio shows, on average, how long it takes to collect cash from customers following the sale of goods on credit. The collection period should be compared with:

- the stated credit policy
- previous period figures
- industry average or competitor.

An increasing accounts receivables collection period is usually a bad sign suggesting a lack of proper credit control which may lead to irrecoverable debts.

It may, however, be due to:

- a deliberate policy to attract more customers, or
- a major new customer being allowed extended credit terms.

Falling receivables days is usually a good sign, though it could indicate that the entity is suffering a cash shortage.

Trade receivables days

The trade receivables used may be a year-end figure or the average for the year. Where an average is used to calculate the number of days, the ratio is the average number of days' credit taken by customers.

For many businesses total revenue can safely be used, because cash sales will be insignificant. But cash-based businesses such as supermarkets make the substantial majority of their sales for cash, so the receivables period should be calculated by reference to credit sales only.

The result should be compared with the stated credit policy. A period of 30 days or 'at the end of the month following delivery' are common credit periods.

The receivables days ratio can be distorted by:

- using year-end figures which do not represent average receivables
- factoring of accounts receivables which results in very low trade receivables
- sales on unusually long credit terms to some customers.

Payables payment period

This is usually expressed as:

$$\frac{\text{Trade payables}}{\text{Credit purchases}} \times 365 = \text{X days}$$

This represents the credit period taken by the entity from its suppliers.

The ratio is always compared to previous years:

- A long credit period may be good as it represents a source of free finance.
- A long credit period may indicate that the entity is unable to pay more quickly because of liquidity problems.

If the credit period is long:

- the entity may develop a poor reputation as a slow payer and may not be able to find new suppliers
- current suppliers may decide to discontinue supplies
- the entity may be losing out on worthwhile cash discounts.

In most sets of financial statements (in practice and in examinations) the figure for purchases will not be available therefore cost of sales is normally used as an approximation in the calculation of the accounts payable payment period.

Cash cycle

We can also consider the cash cycle as part of management of working capital. In effect, it may be regarded as the interaction of the inventory turnover, receivables collection period and payables payment period. The cash cycle is important to a business to ensure that it has adequate cash resources to meet the needs of the business. This may include ensuring that there are sufficient cash resources to do the following:

- to pay current liabilities as they fall due
- to meet any financing commitments that the business may have, such as repayment of loans and finance charges
- to meet regular weekly and/or monthly payroll costs
- to meet any capital commitments that a business may have
- to meet any sales and business tax commitments that a business may have.

The cash conversion cycle ('CCC') can be used to determine how many days cash is tied up on the working capital cycle as follows:

> CCC = inventory holding period + receivables collection period – creditors payment period.

Ideally, businesses would like to have cash tied up in working capital for the minimum number of days possible. In the case of cash retail business, such as a supermarket, the cash conversion cycle will be very short. In the case of a manufacturing business which also sells on credit, the cash conversion cycle will be considerably longer and therefore increase the working capital requirements of the business.

By way of illustration, suppose that two businesses provide you with the following information relating to working capital management:

	Business 1	**Business 2**
Inventory holding period	10 days	30 days
Receivables collection period	0 days	40 days
Payables payment period	(40 days)	(35 days)
	(30 days)	35 days

Business 1 holds inventory for a relatively short period of time and sales are made for cash, so there is no receivables collection period, whilst it also takes 40 days credit from suppliers. Cash is therefore collected in quicker than it is paid out. By contrast, Business 2 holds inventory for 30 days before it is sold, when credit customers then take, on average, forty days credit. This total of seventy days is then offset to the extent that the business takes credit from suppliers, 35 days, leaving a net cash conversion cycle of 35 days.

7 Financial position

When assessing the financial position of a business the main focus is its stability and exposure to risk. This is typically assessed by considering the way the business is structured and financed. This is referred to as **gearing**.

In simple terms gearing is a measure of the level of external debt an entity has (e.g. outstanding loans) in comparison to equity finance (i.e. share capital and reserves).

Measuring gearing

There are two methods commonly used to express gearing as follows.

Debt/equity ratio:

$$\frac{\text{Long term debt}}{\text{Equity}}$$

Percentage of capital employed represented by borrowings:

$$\frac{\text{Long term debt}}{\text{Equity + long term debt}}$$

Long term debt includes non-current loan and redeemable preference share liabilities.

Equity includes share capital and share premium account balances plus reserves (revaluation surplus, retained earnings).

Note: Redeemable preference shares are treated as liabilities because they must be repaid and are therefore debts of the entity. Irredeemable preference shares do not have to be repaid and are therefore treated the same as ordinary shares and included in equity.

High and low gearing

Risk

External debt finance is considered to be risky because there are mandatory, fixed repayment obligations. Failure to repay these amounts could lead to insolvency proceedings against the entity.

Equity finance is less risky because there are no mandatory repayment obligations to shareholders. Failure to pay a dividend would not lead to insolvency proceedings.

Servicing of finance

The costs of servicing equity finance are generally considered to be higher than servicing external debt. This is because equity holders expect a greater return than they could achieve offering a fixed loan to a business entity. Remember that lenders receive fixed, mandatory repayments. They also take out security on the assets of an entity. Equity holders do not have this comfort blanket; they receive no guaranteed returns and they take on considerable risks. They would therefore expect greater returns on their investments; if they could not achieve this they would surely not accept the risk of buying shares and lend their money instead.

Therefore highly geared entities (high level of debt to equity) are considered to be riskier but comparatively cheaper to service than lower geared entities (and vice versa).

Low-geared business entities also tend to provide scope to increase borrowings when potentially profitable projects are available as they are generally perceived to be less risky by banks and can therefore borrow more easily.

Interest cover

This is normally expressed as:

$$\textbf{Interest cover} = \frac{\text{PBIT}}{\text{Interest payable}}$$

Interest cover indicates the ability of an entity to pay interest out of profits generated:

- low interest cover indicates to shareholders that their dividends are at risk (because most profits are eaten up by interest payments),
- the entity may have difficulty financing its debts if its profits fall, and
- interest cover of less than two is usually considered unsatisfactory.

Interest cover

A business must have a sufficient level of long-term capital to finance its long-term investment in non-current assets. Part of the investment in current assets would usually be financed by relatively permanent capital with the balance being provided by credit from suppliers and other short-term borrowings. Any expansion in activity will normally require a broadening of the long-term capital base, without which 'overtrading' may develop (see below).

Suitability of finance is also a key factor. A permanent expansion of an entity's activities should not be financed by temporary, short-term borrowings. On the other hand, a short-term increase in activity such as the 'January sales' in a retail trading entity could ideally be financed by overdraft.

A major addition to non-current assets such as the construction of a new factory would not normally be financed on a long-term basis by overdraft. It might be found, however, that the expenditure was temporarily financed by short-term loans until construction was completed, when the overdraft would be 'funded' by a long-term borrowing secured on the completed building.

Test your understanding 1

Neville Co is an entity that manufactures and retails office products. Its summarised financial statements for the years ended 30 June 20X4 and 20X5 are given below:

Statements of profit or loss for the year ended 30 June

	20X4	**20X5**
	$000	$000
Revenue	1,159,850	1,391,820
Cost of sales	(753,450)	(1,050,825)
Gross profit	406,400	340,995
Operating expenses	(170,950)	(161,450)
Profit from operations	235,450	179,545
Finance costs	(14,000)	(10,000)
Profits before tax	221,450	169,545
Tax	(66,300)	(50,800)
Net profit	155,150	118,745

Statements of financial position as at 30 June

	20X4		**20X5**	
	$000	$000	$000	$000
Non-current assets		341,400		509,590
Current Assets				
Inventory	88,760		109,400	
Receivables	206,550		419,455	
Bank	95,400		–	
		390,710		528,855
		732,110		1,038,445

Equity and reserves				
Share capital	100,000		100,000	
Share premium	20,000		20,000	
Revaluation reserve	–		50,000	
Retained earnings	287,420		376,165	
		407,420		546,165
Non-current liabilities				
Loans		83,100		61,600
Current liabilities				
Payables	179,590		345,480	
Overdraft	–		30,200	
Tax	62,000		55,000	
		241,590		430,680
		732,110		1,038,445

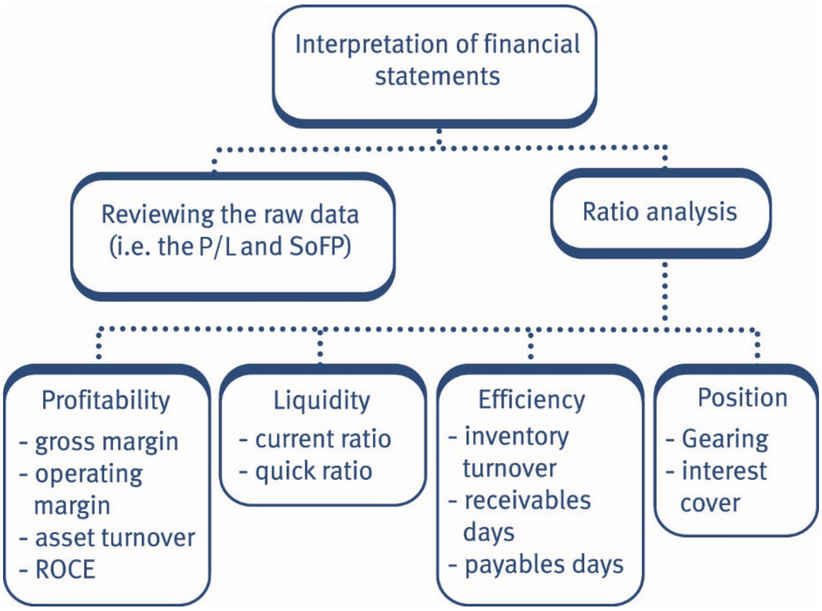
The directors concluded that the revenue for the year ended 30 June 20X4 fell below budget and introduced measures during the year ended 30 June 20X5 to improve the situation. These included:

- cutting selling prices
- extending credit facilities to customers
- leasing additional machinery in order to be able to manufacture more products.

The directors' are now reviewing the results for the year ended 30 June 20X5.

Calculate the ratios for and comment upon the profitability, liquidity/efficiency and financial position of Neville Co for 20X4 and 20X5.

8 Chapter summary



Test your understanding answers

Test your understanding 1

Profitability

	20X4		20X5	
GP%	406,400 / 1,159,850	35.0%	340,995 / 1,391,820	24.5%
OP%	235,450 / 1,159,850	20.3%	179,545 / 1,391,820	12.9%
ROCE	235,450 / 490,520	48.0%	179,545 / 607,765	29.5%
Asset turnover	1,159,850 / 490,520	2.36	1,391,820 / 607,765	2.29

The revenue of the entity has increased by 20% on last year. It would therefore appear that the strategy of cutting prices and extending credit facilities has attracted customers and generated an increase in revenue.

Despite this increase, the operating profit margin has declined from 20.3% to 12.9%.

There are several possible reasons behind this deterioration:

- the reduction in sales prices
- increased leasing costs
- increased depreciation due to the revaluation and additional purchases of non-current assets
- increased irrecoverable debt due to the extended credit facilities.

The return on capital employed has dropped significantly from 48% to 29.5%. The possible reasons for this decline include:

- the reduction in operating profit margins
- the revaluation of non-current assets, which would increase capital employed.

Liquidity/efficiency

	20X4		20X5	
Inventory days	$\frac{88{,}760 \times 365}{753{,}450}$	43 days	$\frac{109{,}400 \times 365}{1{,}050{,}825}$	38 days
Receivables days	$\frac{206{,}550 \times 365}{1{,}159{,}850}$	65 days	$\frac{419{,}455 \times 365}{1{,}391{,}820}$	110 days
Payables days	$\frac{179{,}590 \times 365}{753{,}450}$	87 days	$\frac{345{,}480 \times 365}{1{,}050{,}825}$	120 days
Current ratio	$\frac{390{,}710}{241{,}590}$	1.6:1	$\frac{528{,}855}{430{,}680}$	1.2:1
Quick ratio	$\frac{301{,}950}{241{,}590}$	1.2:1	$\frac{419{,}455}{430{,}680}$	1:1

The entity's results show a deteriorating liquidity position; both the current and quick ratios have deteriorated. The main reasons for this appear to be:

- the reduction in cash and consequent increase in overdrafts
- the increase in trade payables.

The overall cause could be the extension of credit facilities to customers. Credit customers are taking an extra 45 days to pay on average. As a result, Neville Co appears to have less cash to pay its suppliers and it is using its cash resources and overdraft facilities.

Receivables days have increased from an appropriate level of 65 days to 110 days. Although the benefits of this strategy have been shown by the increase in revenue, it would seem that Neville Co has now allowed customers too much credit. It would be recommended that receivables days should be reduced to closer to 90 days.

The large increase in payables days could lead to problems, unless suppliers have specifically agreed to offer Neville Co extended repayment deadlines. If not, then suppliers may refuse to sell goods to Neville Co on a credit basis.

Financial position

	20X4		20X5	
Interest cover	$\frac{235,450}{14,000}$	16.8	$\frac{179,545}{10,000}$	17.9
Gearing*	$\frac{83,100}{490,520}$	16.9%	$\frac{61,600}{607,765}$	10.1%

* Gearing has been calculated using the 'debt/debt + equity' formula.

Gearing has fallen, whilst interest cover has increased. The key reason for this appears to be the reduction in loans (along with the consequent reduction in finance costs) during the year.

It appears as though Neville Co has used cash to repay its loan finance. This does not appear to be a sensible decision because the reduction in cash within the business has led to an increase in expensive overdrafts and an increase in payables days, which may upset suppliers.

Both gearing and interest cover were strong in 20X4 (i.e. the interest cover was more than adequate and the gearing level appeared to be low). This indicated that Neville Co could afford to sustain its loans without significant penalty. It is now using an overdraft facility which is likely to carry a much higher interest charge than long-term loans.

To improve its position Neville Co could seek further long terms loans. It is not a risky business from a gearing perspective and it has plenty of assets to use as security for any lenders.

Chapter

19

Consolidated statement of financial position

Chapter learning objectives

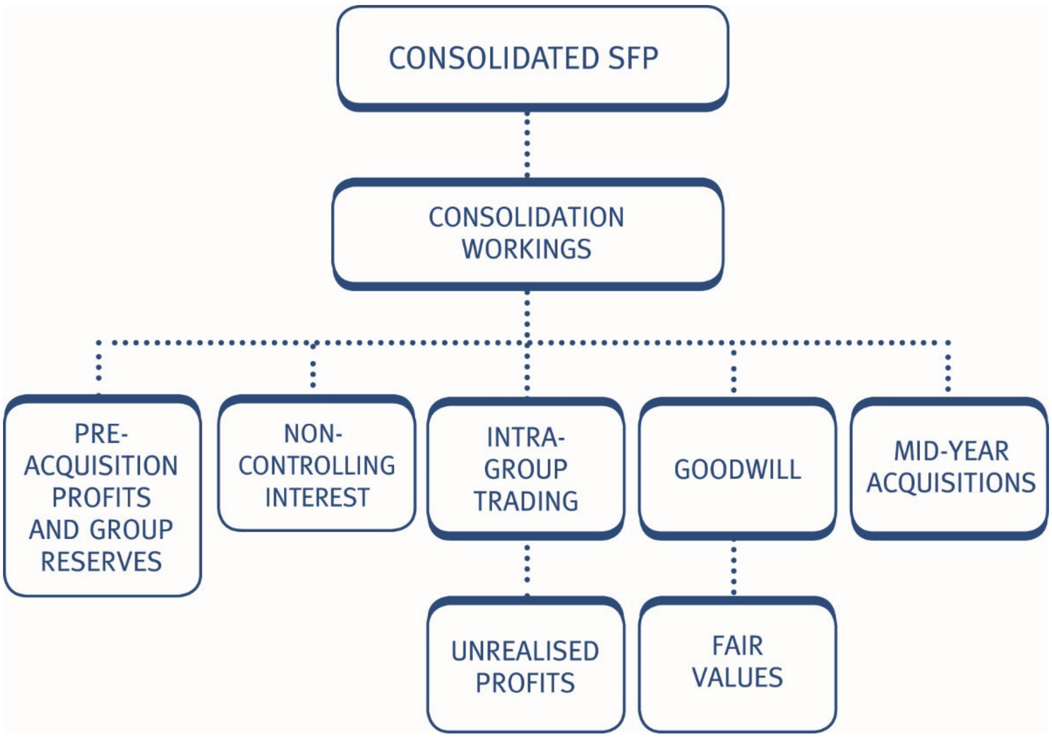
Upon completion of this chapter you will be able to:

- define and describe the following in the context of group accounting
  - (i) parent
  - (ii) subsidiary
  - (iii) control
  - (iv) consolidated or group financial statements
  - (v) non-controlling interest
  - (vi) trade/simple investment
- describe the components of and prepare a consolidated statement of financial position or extracts thereof, including the following adjustments:
  - (i) fair values
  - (ii) intra-group trading
  - (iii) unrealised profits
  - (iv) acquisition part-way through the year
- calculate goodwill using the full goodwill method.

PER

One of the PER performance objectives (PO7) is to prepare and review financial statements in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter introduces consolidated accounts, including key definitions and the workings required to produce a consolidated statement of financial position. The chapter also introduces some of the standard accounting adjustments that may be required when preparing consolidated financial statements.

The preparation of consolidated financial statements is a key topic within both Financial Reporting and Strategic Business Reporting.

2 What is a group?

A group exists where one entity, the **parent** (referred to as **'the investor'**), has control over another entity, the **subsidiary** (referred to as **'the investee'**),

In accordance with IFRS 10 Consolidated Financial Statements specifies three criteria that must apply if one entity is to have control over another as follows:

(i) **power over the investee, which is normally exercised through the majority of voting rights (i.e. owning more than 50% of the equity shares),**

(ii) **exposure or rights to variable returns from involvement (e.g. a dividend), and**

(iii) **the ability to use power over the investee to affect the amount of investor returns. This is regarded as a crucial determinant in deciding whether or not control is exercised** (IFRS 10, para 7).

A parent is an entity that controls one or more entities (IFRS 10, Appendix A).

A subsidiary is an entity that is controlled by another entity (IFRS 10. Appendix A).

A **trade investment** is one in which the investor neither a subsidiary, or an associate (see the following chapter). It is accounted for as a financial asset and normally measured at fair value at each reporting date.

Control is normally indicated by the parent holding a majority of the issued equity or voting shares (anything over 50%) in the subsidiary. Note that it may be possible for one entity to control another by holding less than 50% of the equity or voting shares. This may occur, for example, in the following situations:

1 if the majority shareholder held, say, 48% of the shares with all other shares held by unconnected shareholders who were not acting in unison. Some of the unconnected shareholders may vote in favour of a particular resolution, whilst others may vote against the resolution or perhaps even abstain from voting. In practical terms, the majority shareholder would have a working majority to pass resolutions and act, to all intents and purposes, as the majority shareholder with voting control.

2 if the majority shareholder held, say, 45% of the shares and that shareholder had a contractual agreement with the remaining shareholders that the majority shareholder could exercise voting control, or perhaps there were other agreements in place that enabled it to become the majority shareholder.

3 Requirement to prepare consolidated financial statements

If one entity controls another then IFRS 10 requires that a single set of consolidated financial statements be prepared to reflect the financial performance and position of the group as one combined entity. This reflects the fact that the investment of the parents' shareholders is now tied up in more than one entity. Their returns and the stability of their investment now reflect the performance and position of both entities.

In order to make informed decisions about their investment, shareholders would need to read and interpret the financial statements of both entities. If there were more than one subsidiary entity this could become quite complex for shareholders. To this end one set of financial statements is prepared where the revenues, expenses, assets and liabilities of the parent and subsidiary are combined for ease of understanding and analysis.

4 The basic method of preparing a consolidated statement of financial position

The key points relating to the preparation of a consolidated statement of financial position are as follows:

1 The assets and liabilities of the parent and the subsidiary are added together on a line-by-line basis.

2 The investment in the subsidiary included in the parent's SoFP is replaced by a goodwill asset in the consolidated SoFP.

3 The equity (ordinary) share capital and share premium balances of the parent and subsidiary are not added together; only the parent entity balances for equity share capital and share premium are included in the consolidated SoFP. This reflects the fact that the consolidated SoFP includes all of the assets and liabilities under the control of the parent entity.

4 The amount attributable to non-controlling interests is calculated and shown separately on the face of the consolidated SoFP.

5 The group share of the subsidiary's post-acquisition retained earnings is calculated and included as part of group retained earnings.

Note that it is not necessary for a parent to own all of the equity or voting shares in another entity to have control. Voting control is normally achieved by owning a majority (in excess of 50%) of the equity or voting shares. To the extent that there are 'outside' or 'external shareholders in the subsidiary, they are referred to as a **'non-controlling interest' i**.e. they have a financial and voting interest in the subsidiary, but are not in a position to exercise control – that is done by the controlling parent.

Non-controlling interests

Often when a parent entity controls a subsidiary it is due to the fact that it controls voting rights (i.e. it owns more than 50% of the voting share capital). It is possible that it does not own all the shares, which means there are other, minority, shareholders. These are known as non-controlling interests.

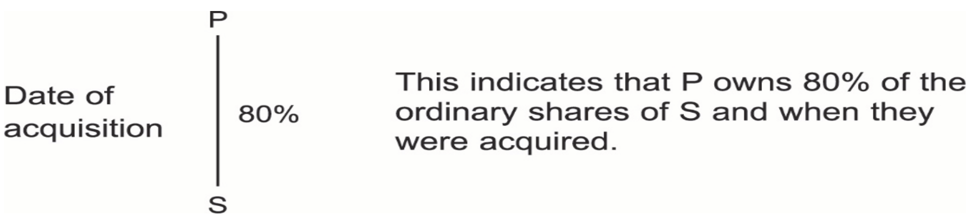
For example: if the parent owns 80% of the equity (ordinary) share capital it is likely to have control due to the majority of voting rights it controls (unless proven otherwise). The remaining 20% of shareholders are the non-controlling interests.

5 The mechanics of consolidation

You need to be familiar with the standard workings required to prepare a consolidated statement of financial position. Whilst you are gaining familiarity and understanding with this procedure, it is helpful to go through the standard workings in the same sequence.

(W1) Establish the group structure

This is where you establish whether there is a parent-subsidiary relationship (i.e. does the parent have control?). You will need to identify the percentage of ordinary/equity shares held by the parent in the subsidiary, along with the non-controlling interest percentage and the date control was acquired.



(W2) Net assets of subsidiary

	At date of acquisition	At the reporting date
	$	$
Equity share capital	X	X
Share premium	X	X
Revaluation surplus	X	X
Retained earnings	X	X
	X	X

The total of issued share capital and share premium from the subsidiary SoFP should be unchanged at both the date of acquisition and the reporting date.

(W3) Goodwill

	$
Fair value (FV) of consideration paid	X
FV of non-controlling interest (NCI) at acquisition	X
	X
Less: FV of net assets at acquisition (W2)	(X)
Goodwill at acquisition	X

(W4) Non-controlling interest

	$
FV of NCI at acquisition (as in W3)	X
NCI share of post-acquisition reserves (W2)	X
	—
NCI at reporting date	X
	—

(W5) Group retained earnings

	$
P's retained earnings (100%)	X
P's % of sub's post-acquisition retained earnings	X
	—
Group retained earnings are reporting date	X
	—

6 Goodwill

The value of an entity will normally exceed the value of its net assets. The difference is **goodwill.** IFRS 3 Business Combinations requires that goodwill is recognised at the date of acquisition and accounted for as an intangible non-current asset in the consolidated statement of financial position.

This represents assets not included in the statement of financial position of the acquired entity such as the reputation of the business, brand and the experience of employees. Goodwill arises because the investor would rather buy a ready-made and established business than buy the individual components and set up the business themselves from the beginning. As such, the investor is buying into an entity which is a going concern and already has established products and services to sell, an established customer base and supplier network, along with trained an experienced employees.

Illustration 1 – H Group

In order to illustrate the basic principles involved in a consolidated statement of financial position we will use the following example of H group, performing each calculation in turn and finally compiling the consolidated statement of financial position. Note that, in this illustration, H owns all of the shares issued by S and, therefore, there is no non-controlling interest to account for.

The statements of financial position of H and S as at 31 December 20X8 were as follows.

	H	**S**
	$	$
Non-current assets:		
Property, plant & equipment	85,000	18,000
Investments:		
Shares in S	60,000	
	145,000	
Current assets	160,000	84,000
	305,000	102,000
Equity:		
Equity shares @ $1 each	65,000	20,000
Share premium	35,000	10,000
Retained earnings	70,000	25,000
	170,000	55,000
Current liabilities	135,000	47,000
	305,000	102,000

H acquired a 100% holding in S on 1 January 20X8. At that date S's retained earnings were $15,000.

Prepare the consolidated statement of financial position for the H group as at 31 December 20X8.

Solution to Illustration 1

Group statement of financial position of H group as at 31 December 20X8

		$
Non-current assets:		
Goodwill at acquisition (W3)		15,000
Property, plant & equipment	($85,000 + $18,000)	103,000
		118,000
Current assets	($160,000 + $84,000)	244,000
		362,000
Equity:		
Equity shares @ $1 each (H only)		65,000
Share premium (H only)		35,000
Group retained earnings (W5)		80,000
		180,000
Current liabilities	($135,000 + $47,000)	182,000
		362,000

(W1) Group structure

H

100% owned NCI% = nil

S

(W2) Net assets of S

	At date of acquisition	At reporting date
	$	$
Share capital	20,000	20,000
Share premium	10,000	10,000
Retained earnings	15,000	25,000
Net assets	45,000	55,000

(W3) Goodwill

	$
FV of consideration paid	60,000
FV of NCI at acquisition	N/A
	60,000
Less:	
FV of net assets at acquisition (W2)	(45,000)
Goodwill at acquisition (to SoFP)	**15,000**

(W4) Non-controlling interest – not applicable as H owns 100% of the issued share capital of S.

(W5) Group retained earnings

	$
H retained earnings per SoFP	70,000
Group share of S post-acquisition retained earnings (100% × ($25,000 – $15,000))	10,000
Group retained earnings at reporting date (to SOFP)	**80,000**

Fair values

When calculating goodwill and non-controlling interests the fair value method is used. This means that amounts are not calculated merely at their reported carrying amount at the date of acquisition.

Goodwill is the difference between the amount paid to acquire a controlling shareholding in another entity and the fair value of the assets acquired. However, the amount paid is not always a simple cash transaction paid in full at the date of acquisition. With large entities, shares are often purchased for cash plus one or more additional payments that are deferred until some future date. Sometimes, the deferred payments are contingent upon achieving certain performance targets. Deferred consideration and contingent consideration are not within the ACCA Financial Accounting syllabus.

Additionally, all or part of the consideration paid may consist of a share exchange between the parent entity and the shareholders in the subsidiary who sold their shares to the parent. All of these elements of the 'consideration' must be valued in today's monetary terms as at the date of acquisition.

The value of the shareholding must also be considered. The net assets are usually calculated by totalling the assets reported on the SoFP and deducting liabilities. However, we have seen already that the book or carrying amounts often do not reflect their true market or fair value. This is most common with property, plant and equipment. Property often appreciates in value, whereas in the financial statements of some entities it is stated at depreciated historic cost. Therefore the fair value of all assets and liabilities must be determined.

Fair value adjustments are explained in greater detail later in this chapter.

Illustration 2 – D Group

In order to illustrate the various workings involved in a consolidated statement of financial position we will use the example of D group, performing each calculation in turn and finally compiling the consolidated statement of financial position.

The statements of financial position of D and J as at 31 December 20X8.

	D	**J**
	$	$
Non-current assets:		
Property, plant & equipment	85,000	18,000
Investment: Shares in J	60,000	
	145,000	
Current assets	160,000	84,000
	305,000	102,000
Equity:		
Equity shares @ $1	65,000	20,000
Share premium	35,000	10,000
Retained earnings	70,000	25,000
	170,000	55,000
Current liabilities	135,000	47,000
	305,000	102,000

D acquired an 80% holding in J on 1 January 20X8. At this date J's retained earnings stood at $20,000. On this date, the fair value of the 20% non-controlling shareholding in J was $12,500.

Calculate goodwill arising on the acquisition of J.

Text Solution to Illustration 2

(W1) Group structure

	D	
1 Jan X8	80%	Note: NCI = 20%
	J	

(W2) Net assets of J

	At date of acquisition	At reporting date
	$	$
Share capital	20,000	20,000
Share premium	10,000	10,000
Retained earnings	20,000	25,000
Net assets	50,000	55,000

(W3) Goodwill

	$
FV of consideration paid	60,000
FV of NCI at acquisition	12,500
	72,500
Less: FV of net assets at acquisition (W2)	(50,000)
Goodwill on acquisition (to SoFP)	**22,500**

Test your understanding 1

Daniel acquired 80% of the equity share capital of Craig on 31 December 20X6 for $78,000. At this date the fair value of the net assets of Craig were $85,000. NCI is valued using the fair value method and the fair value of the NCI at the acquisition date was $19,000.

What goodwill arises on the acquisition?

7 Accounting treatment of non-controlling interest

Don't forget that where a group exists the parent controls the subsidiary, so the financial statements of those two entities are consolidated. The non-controlling interests represent the 'other' shareholders of the subsidiary, where the parent owns less than 100% of the equity shares.

In the consolidated statement of financial position all of the assets and liabilities of the parent and subsidiary are added together at the reporting date. They are **NOT APPORTIONED**. On the lower part of the consolidated SoFP an amount is recognised that allocates a portion (i.e. their share) of the net assets of the subsidiary to the non-controlling interests. This effectively recognises their share of the value of that entity.

Illustration 3 – Non-controlling interest

Using the information for D Group from Illustration 2, calculate the non-controlling interest to include in the statement of financial position at 31 December 20X8.

Solution to Illustration 3

(W4) Non-controlling interests

FV of NCI at acquisition (as in W3)	12,500
NCI share of post-acquisition reserves (W2)	
(20% × (55,000 – 50,000))	1,000
	13,500

8 Group retained earnings and other components of equity

Pre-acquisition profits are the retained earnings of the subsidiary which exist at the date when control was acquired by the parent. These profits belong to the previous shareholders as the profits were earned during their period of ownership. The new parent cannot lay claim to these profits so these profits are excluded from group retained earnings.

Post-acquisition profits are those profits recognised in retained earnings by the subsidiary at the year-end but earned since the new parent purchased its controlling interest. As these were earned during the ownership of the new parent an appropriate percentage (based upon the parent's % ownership) can be recognised in group retained earnings.

In the same way that retained earnings are allocated between pre- and post-acquisition elements, the same also applies to revaluation surplus if it is part of the subsidiary's statement of financial position. Normally, you will be provided with the revaluation surplus value at the date of acquisition, with any amount in excess of this regarded as a post-acquisition movement.

The mechanics of accounting for the post-acquisition increase in revaluation surplus are similar to accounting for the increase in retained earnings. If there has been no change in the revaluation surplus balance between the date of acquisition and the reporting date of the statement of financial position you are dealing with, it is treated as a pre-acquisition balance.

If the balance on revaluation surplus has increased between the date of acquisition and the reporting date of the statement of financial position you are dealing with, the increase is treated in a similar manner to the increase in retained earnings. The group share of the increase is included in the consolidated statement of financial position as a separate component of equity (don't include it as part of group retained earnings!). The non-controlling interest share of the increase is allocated to the non-controlling interest shareholders within (W4) of the standard consolidation workings.

Illustration 4 – Retained earnings

Using the information for D Group from Illustration 2, calculate the group retained earnings to include in the group statement of financial position at 31 December 20X8.

Solution to Illustration 4

(W5) Group retained earnings

	$
100% D's retained earnings	70,000
80% J post-acquisition retained earnings	4,000
80% × ($55,000 – $50,000) (W2)	
	74,000

Illustration 5 – The consolidated SoFP

Using the information from Illustration 2 and the consequent calculations performed, prepare the consolidated statement of financial position of D Group as at 31 December 20X8.

Solution to Illustration 5

D consolidated statement of financial position as at 31 December 20X8

Non-current assets	$
Goodwill (W3)	22,500
PPE ($85,000 + $18,000)	103,000
Current assets ($160,000 + $84,000)	244,000
	369,500
Equity	
Share capital	65,000
Share premium	35,000
Group retained earnings (W5)	74,000
Non-controlling interest (W4)	13,500
	187,500
Current liabilities ($135,000 + $47,000)	182,000
	369,500

9 Fair values

To ensure that a reliable figure is calculated for goodwill:

- the consideration paid for a subsidiary must be accounted for at fair value
- the subsidiary's identifiable assets and liabilities acquired must be accounted for at their fair values.

Fair value is defined as **"the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."** i.e. it is an exit price (IFRS 13, para 9).

The need to account on a fair value basis reflects the fact that the statement of financial position often values items (mainly non-current assets) at their historic cost less depreciation. This could mean the carrying amount of assets is significantly different to their current market values, particularly in the case of assets that tend to appreciate in value, such as land and buildings.

Fair values

The subsidiary's identifiable assets and liabilities are included in the consolidated accounts at their fair values for the following reasons.

- Consolidated accounts are prepared from the perspective of the group, rather than from the perspectives of the individual entities. The book values of the subsidiary's assets and liabilities are largely irrelevant, because the consolidated accounts must reflect their cost to the group (i.e. to the parent), not their original cost to the subsidiary. The cost to the group is their fair value at the date of acquisition.
- Purchased goodwill is the difference between the value of an acquired entity and the aggregate of the fair values of that entity's identifiable assets and liabilities. If fair values are not used, the value of goodwill will be meaningless.

Including the fair value of net assets acquired in consolidation workings

1 Adjust both columns of W2 to bring the net assets to fair value at acquisition and reporting date. This will ensure that the fair value of net assets is carried through to the goodwill and non-controlling interest calculations.

	At acquisition	At reporting date
	$000	$000
Equity share capital	X	X
Share premium	X	X
Revaluation surplus	X	X
Retained earnings	X	X
Fair value adjustments	X	X
	X	X

The fair value adjustment represents the amount required to adjust the relevant item from its current carrying amount in the subsidiary SoFP to its identified fair value.

Note that the total of issued share capital and share premium balances of the subsidiary will be the same at the date of acquisition and at the reporting date.

If you have different values for issued share capital at these dates, either or both figures will be wrong. Similarly, if the subsidiary has a share premium account, the share premium carrying amount should be the same at both dates.

2 At the reporting date make the adjustment on the face of the SoFP when adding across assets and liabilities.

Including the fair value of consideration paid in consolidation workings

1 Confirm the basis of the share exchange between the parent entity (P) and the subsidiary entity (S) shareholders who have agreed to sell their equity shares e.g. the proportion of the subsidiary entity's issued share capital that has been acquired by the parent, along with the relevant ratio or proportion to calculate the number of equity shares that the parent should issue, along with the fair value of a share.in the parent.

2 Calculate the fair value of consideration paid based upon the share exchange for use in the goodwill calculation in W3 as follows:

S issued share capital × %age acquired by P × ratio × FV of P share

3 Check to see if P has accounted for the issue of shares and the cost of the investment in S in its own statement of financial position. If not, you will need to do this as follows:

Debit: Cost of investment (fair value of shares issued)	$m
Credit: Issued share capital (nominal value of shares issued)	$m
Credit: Share premium (premium on shares issued)	$m

4 Ensure that the increase in issued equity share capital and share premium is also reflected in the consolidated statement of financial position.

Remember that, in addition to a share exchange, the parent may also make an immediate payment of cash as part of the agreement to purchase a controlling interest in another entity.

e.g

Illustration 6 – Fair value of consideration paid

Hoe acquired a 75% interest in the equity share capital of Spade on 1 January 20X6. The consideration consisted of an immediate cash payment of $1.80 per share acquired plus Hoe agreed to issue 2 shares in exchange for every 3 acquired. At the date of acquisition, Spade had 2 million equity shares of $1 nominal value each in issue. The market or fair value of a $1 Hoe share at 1 January 20X6 was $3.

Calculate the fair value of consideration paid by Hoe to acquire control of Spade and state the accounting entries required to account for the increase in share capital and share premium.

Solution to Illustration 6

Number of shares acquired by Hoe = 75% × 2 million = 1.5 million

Cash paid = $1.80 × 1.5 million = $2.7 million

Accounting entries:

Debit: Cost of Investment $2.7 million, and

Credit Bank $2.7 million

Number of shares issued by Hoe = 1.5 million × 2/3 = 1 million

Fair value of shares issued by Hoe = 1 million × $3 = $3 million

Increase in issued share capital of Hoe = 1 million × $1 = $1 million

Increase in share premium of Hoe = 1 million × $2 = $2 million

Accounting entries:

Debit: Cost of investment $3 million,

Credit: Issued share capital $1 million, and

Credit: Share premium $2 million

Total of fair value of consideration paid by Hoe (per cost of investment a/c) for use in W3 to calculate goodwill:

Cash paid $2.7m + Fair value of shares issued $3m = $5.7 million.

Illustration 7 – Fair value adjustments

Hazelnut acquired 80% of the share capital of Peppermint on 1 January 20X3 for cash consideration of $1 million. At the date of acquisition, Peppermint had retained earnings of $125,000 and a revaluation surplus of $100,000.

At acquisition the fair value of Peppermint's plant exceeded its carrying amount by $200,000. At the date of acquisition, the fair value of the 20% non-controlling interest in Peppermint was $380,000.

Below are the statements of financial position of Hazelnut and Peppermint as at 31 December 20X4:

	Hazelnut	Peppermint
	$000	$000
Investment in Peppermint at cost	1,000	
Property, plant & equipment	5,500	1,500
Current assets:		
Inventory	550	100
Receivables	400	200
Bank	200	50
	7,650	1,850
Share capital	1,800	400
Revaluation surplus	200	100
Retained earnings	1,400	300
	3,400	800
Non-current liabilities	3,000	400
Current liabilities	1,250	650
	7,650	1,850

Calculate the fair value of the net assets of Peppermint at the date of acquisition and at the reporting date (i.e. Working 2).

Solution to Illustration 7

(W2) Net assets of Peppermint

	At date of acquisition	At reporting date
	$000	$000
Share capital	400	400
Revaluation surplus	100	100
Retained earnings	125	300
Plant fair value adjustment	200	200
	825	1,000

Test your understanding 2

Prepare the consolidated statement of financial position of Hazelnut Group as at 31 December 20X4. Include all relevant workings.

10 Intra-group trading

Types of intra-group trading

P and S may well trade with each leading to the following potential issues to be dealt with:

- receivables and payables in P and S that effectively cancel each other out
- dividends paid by the subsidiary recognised as income by the parent. Similarly, if a dividend is paid by one entity and received by the other, the net effect of this to the group is zero.
- unrealised profits on sales of inventory between the parent and the subsidiary. So that you can understand this concept consider the following question: can you make a profit if your right hand sells goods to your left hand? Obviously not and for the same reason a group cannot make profit when one part of the group sells goods to another part.

Current accounts

If P and S trade with each other, this will probably be done on credit leading to:

- a receivable (current) account in one entity's SoFP
- a payable (current) account in the other entity's SoFP.

These amounts should not be consolidated because the group would end up with a receivable to itself and a payable to itself – receivables and payables would consequently be overstated in the consolidated SoFP.

These balances are therefore cancelled (contra'd) against each other on consolidation.

e.g

Illustration 8

Statements of financial position of P and S as at 30 June 20X8 are given below:

	P	S
	$	$
Non-current assets: Land	4,500	2,500
Plant & equipment	2,400	1,750
Investments	8,000	–
	14,900	4,250
Current assets		
Inventory	3,200	900
Receivables	1,400	650
Bank	600	150
	5,200	1,700
	20,100	5,950
Equity and liabilities	$	$
Equity		
Equity share capital of 50c each	5,000	1,000
Retained earnings	8,300	3,150
	13,300	4,150
Non-current liabilities	4,000	500
Current liabilities	2,800	1,300
	20,100	5,950

P acquired 75% of S on 1 July 20X5 when the balance on S's retained earnings was $1,150. P paid $3,500 for its investment in the share capital of S.

At the reporting date P recorded a payable to S of $400. This agreed to the corresponding amount in S's financial statements.

At the date of acquisition it was determined that S's land, carried at cost of $2,500, had a fair value of $3,750. At that date, S's plant was determined to have a fair value of $500 in excess of its carrying amount. The fair values had not been recorded by S.

The P group uses the fair value method to value the non-controlling interest which was $1,100 at the date of acquisition.

Calculate the consolidated receivables and payables figures of P group as at 30 June 20X8.

Solution to Illustration 8

Receivables = $1,400 + $650 – **$400** = $1,650

Payables = $2,800 + $1,300 – **$400** = $3,700

Test your understanding 3

Prepare the consolidated statement of financial position of P group, based on the preceding illustration, as at 30 June 20X8.

11 Unrealised profits

Profits made by members of a group on transactions with other group members are:

- recognised in the accounts of the individual entities concerned, but
- in terms of the group as a whole, such profits are unrealised and must be eliminated from the consolidated accounts (remember you cannot make profits if your right hand sells goods to your left!).

Such unrealised profits arise when one group entity sells goods to another group entity and those goods have not yet been sold on externally by the end of the year. They are therefore known as unrealised profits held in inventory.

Intra-group trading and unrealised profit in inventory

When one group entity sells goods to another a number of adjustments may be needed.

- Current accounts must be cancelled (see earlier in this chapter).
- Where goods are still held by one entity at the reporting date, any unrealised profit must be cancelled.
- Inventory must be included at original cost to the group.

Adjustments for unrealised profit in inventory

1 Determine the value of closing inventory still held within the group at the reporting date that are the result of intra-group trading.

2 Use either the profit mark-up or sales margin to calculate how much of that value represents profit earned by the selling entity. The question will identify whether goods have been sold subject to either a mark-up or margin as appropriate.

3 Make one of the following adjustments:

If the seller is the parent, the profit element is included in that entity's accounts and relates entirely to the controlling group.

Adjustment required:

Dr Group retained earnings $X (deduct the profit in W5)

Cr Group inventory $X

If the seller is the subsidiary, the profit element is included in the subsidiary's accounts and relates partly to the group, partly to non-controlling interests (if any).

Adjustment required:

Dr Subsidiary retained earnings	$X (deduct the profit in W2 – at reporting date)
Cr Group inventory	$X

Unrealised profit adjustment alternative

The simple adjustment when the seller is the subsidiary is to adjust the subsidiary's retained earnings in working 2. However if you are not preparing all the workings an alternative method is as follows:

Dr Group retained earnings (group %)	$X (W5)
Dr Non-controlling interests (NCI %)	$X (W4)
Cr Group inventory (100%)	$X (SOFP)

e.g

Illustration 9

H acquired 90% of the equity share capital of S on 1 January 20X2 when the retained earnings of S were $5,000. Statements of financial position at 31 December 20X3 were as follows:

	H		S	
	$000	$000	$000	$000
Non-current assets:				
Property, plant & equipment		100		30
Investment in S at cost		34		
		134		30
Current assets:				
Inventory	90		20	
Receivables	110		25	
Bank	10		5	
		210		50
		344		80

Equity and liabilities:		
Equity:	$000	$000
Share capital of $1 each	15	5
Retained earnings	159	31
	174	36
Non-current liabilities	120	28
Current liabilities	50	16
	344	80

S sold goods to H at a transfer price of $18,000, including a mark-up of 50%. Two-thirds of those goods remained in inventory at the year-end. The current accounts in H and S stood at $22,000 on that day.

The H group uses the fair value method to value the non-controlling interest. The fair value of the non-controlling interest at acquisition was $4,000.

Calculate the unrealised profit adjustment required for the consolidated statement of financial position of H Group. Show the relevant correcting journal.

Solution to Illustration 9

Provision for unrealised profit or 'PURP'

Sales	$18,000	150%
COS		100%
Gross profit	$6,000	50%

The total profit made on the transaction was $6,000. If two-thirds of the goods remain in inventory at the end of the year, that means $4,000 of unrealised profit remains within the group ($6,000 × 2/3).

Double-entry adjustment when the subsidiary sells to the parent:

Dr S's retained earnings at reporting date (W2) $4,000

Cr Group inventory $4,000

Note that this method still needs to account for the allocation of the adjustment for unrealised profit between the parent and subsidiary. This will be achieved when accounting for the respective group and non-controlling interest share of the movement in net assets i.e. when compiling workings (4) and (5) for a group statement of financial position. This is normally the approach to adopt when answering a long form question.

Alternative:

Dr Group retained earnings (90%) $3,600

Dr Non-controlling interests (10%) $400

Cr Group inventory $4,000

Note that the alternative has allocated part of the adjustment for unrealised profit to the non-controlling interest, based upon their shareholding. This is usually the approach to adopt when answering multiple-choice or objective test questions.

Test your understanding 4

Prepare the consolidated statement of financial position for the H Group, based on the preceding illustration, as at 31 December 20X3.

12 Mid-year acquisitions

Calculation of reserves at date of acquisition

If a parent entity acquires a subsidiary mid-year, the net assets must be calculated at the date of acquisition.

The net assets at acquisition can be calculated as the net assets at the start of the subsidiary's financial year plus the retained for part of the year up to the date of acquisition, together with any fair value adjustments at the date of acquisition.

To calculate this, it is normally assumed that S's profit after tax has accrued evenly throughout the year.

Illustration 10

Consolidated statement of financial position

On 1 May 20X7 K acquired 60% of S, paying $76,000 cash. The summarised statements of financial position of the two entities at 30 November 20X7 were:

	K	**S**
	$	$
Non-current assets:		
Property, plant & equipment	138,000	115,000
Investments	98,000	–
Current assets:		
Inventory	15,000	17,000
Receivables	19,000	20,000
Bank	2,000	–
	272,000	152,000

Equity and liabilities:		
Equity:		
Share capital of $1 each	50,000	40.000
Retained earnings	189,000	69.000
	239,000	109,000
Current liabilities:	33,000	43,000
	272,000	152,000

The following information is relevant:

1 At 30 November 20X7, the inventory of S included goods purchased at a cost of $8,000 from K at cost plus 25%. None of the goods had been sold on by S by the reporting date.

2 The K Group values the non-controlling interest using the fair value method. At the date of acquisition the fair value of the 40% non-controlling interest was $50,000.

3 S earned a profit after tax for the year of $9,000 in the year ended 30 November 20X7.

Calculate group retained earnings of K Group as at 30 November 20X7.

Solution to Illustration 10

Net assets	**Acquisition date**	**Reporting date**
	$	$
Share capital of $1 shares	40,000	40,000
Retained earnings	63,750	69,000
	103,750	109,000

RE @ acq'n (balance) (ß)	63,750
Post-acq profit (7/12 × $9,000)	5,250
RE @ reporting date	69,000

PURP – Inventory

Profit in inventory (25/125 × $8,000) = $1,600

Group retained earnings

	$
100% K	189,000
PURP	(1,600)
60% S post-acq profit	
(60% × ($109,000 – $103,750 (W2)))	3,150
	190,550

Test your understanding 5

Prepare the consolidated statement of financial position of K Group, based upon the preceding illustration, as at 30 November 20X7.

Test your understanding 6

The following statements of financial position were extracted from the books of two entities at 31 December 20X9.

	DOC	**CRU**
	$	$
Non-current assets:		
Property, plant & equipment	75,000	11,000
Investments (shares in CRU)	27,000	
	102,000	
Current assets	214,000	33,000
	316,000	44,000

Equity and liabilities:		
Equity:		
Share capital	80,000	4,000
Share premium	20,000	6,000
Retained earnings	40,000	9,000
	140,000	19,000
Current liabilities	176,000	25,000
	316,000	44,000

DOC acquired all of the share capital of CRU on 1 January 20X9. The retained earnings of CRU were $2,000 at the date of acquisition.

Required:

Complete the following tasks relating to the consolidated financial statement of DOC and CRU.

Task 1:

(a) **Choose the correct calculation of goodwill upon acquisition of CRU.** **(2 marks)**

		Selected answer
(i)	$27,000 – ($4,000 + 6,000 + $9,000)	
(ii)	$27,000 – (4,000 + $2,000)	
(iii)	$27,000 – ($4,000 + $6,000 + $2,000)	

(b) **Identify which one of the following would be the correct classification for goodwill in the consolidated statement of financial position.** **(1 mark)**

		Selected answer
(i)	A non-current liability	
(ii)	An intangible non-current asset	
(iii)	A tangible non-current asset	

Task 2

Complete the following table to state at what amount each of the following items should be included in the consolidated statement of financial position at 31 December 20X9.

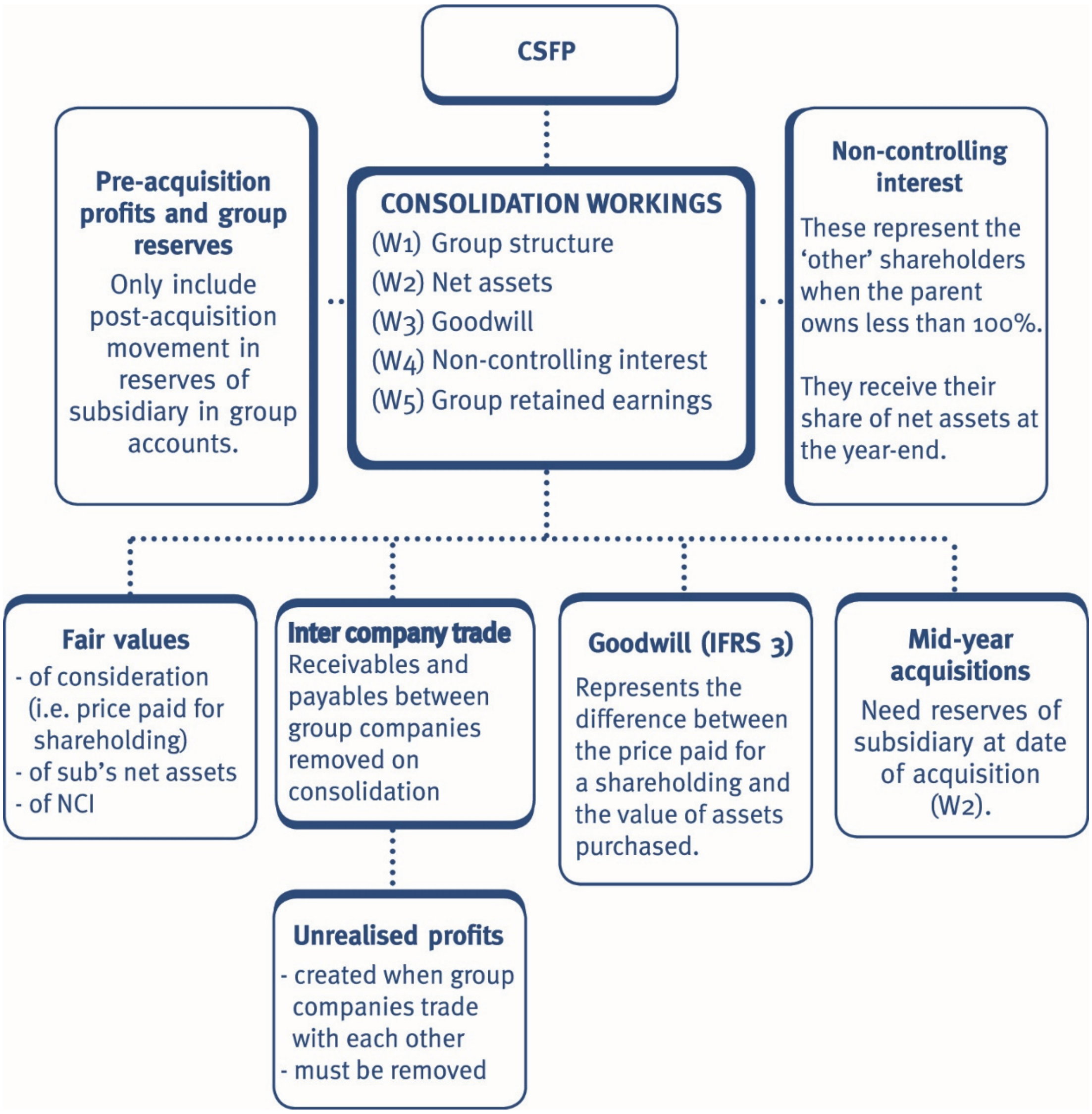
		$
(i)	Property, plant and equipment	
(ii)	Current assets	
(iii)	Equity share capital	
(iv)	Share premium	
(v)	Current liabilities	

Task 3

What amount should be included in the consolidated statement of financial position for retained earnings as at 31 December 20X9?

$

13 Chapter summary



Test your understanding answers

Test your understanding 1

	$
Fair value of consideration	78,000
FV of NCI at acquisition	19,000
	97,000
Less:	
Fair value of net assets at acquisition	(85,000)
Goodwill on acquisition	12,000

Test your understanding 2

Hazelnut consolidated statement of financial position at 31 December 20X4

	$000
Goodwill (W3)	555
Property, plant & equipment ($5,500 + $1,500 + $200)	7,200
Current assets:	
Inventory ($550 + $100)	650
Receivables ($400 + $200)	600
Bank ($200 + $50)	250
	9,255

	$000
Share capital	1,800
Revaluation surplus	200
Retained earnings (W5)	1,540
	3,540
Non-controlling interest (W4)	415
	3,955
Non-current liabilities ($3,000 + $400)	3,400
Current liabilities ($1,250 + $650)	1,900
	9,255

Note that the revaluation surplus of the subsidiary is a pre-acquisition balance and is therefore not part of group revaluation surplus at the reporting date.

Workings

(W1) Group structure

Hazelnut

2 years ago | 80% **Note:** NCI = 20%

Peppermint

(W2) Net assets of Peppermint

	At date of acquisition	At reporting date
	$000	$000
Equity share capital	400	400
Revaluation surplus	100	100
Retained earnings	125	300
Fair value adjustment: plant	200	200
	825	1,000

Note that, as there is no movement in revaluation surplus balance, all of the movement in net assets relates to retained earnings.

(W3) Goodwill

	$000
Fair value of consideration paid:	
Cash paid	1,000
FV of NCI at acquisition	380
	1,380
Less:	
Fair value of net assets at acquisition (W2)	(825)
Goodwill on acquisition	555

(W4) Non-controlling interest

	$000
FV of NCI at acquisition (as in W3)	380
NCI share of post-acquisition reserves (20% × (1,000 – 825) (W2))	35
	415

(W5) Group retained earnings

	$000
Hazelnut retained earnings	1,400
Peppermint (80% × (1,000 – 825))	140
	1,540

Test your understanding 3

Consolidated statement of financial position as at 30 June 20X8

Non-current assets	$
Goodwill (W3)	700
Land ($4,500 + $2,500 + $1,250 (W2))	8,250
Plant & equipment ($2,400 + $1,750 + $500 (W2))	4,650
Investments ($8,000 – $3,500 (cost of investment in S))	4,500
	18,100
Current Assets	
Inventory ($3,200 + $900)	4,100
Receivables ($1,400 + $650 – $400 (inter-co))	1,650
Bank ($600 + $150)	750
	24,600
Equity and Liabilities:	
Equity	
Share capital of 50c each	5,000
Retained earnings (W5)	9,800
Non-controlling Interest (W4)	1,600
	16,400
Non-current liabilities ($4,000 + $500)	4,500
Current liabilities ($2,800 + $1,300 – $400 (inter-co))	3,700
	24,600

Workings

(W1) Group structure

P

75%

S

1 July 20X5 i.e. 3 yrs

(W2) Net assets

	Acquisition date	Reporting date
	$	$
Share capital	1,000	1,000
Retained earnings	1,150	3,150
FV Adj Land ($3,750 – $2,500)	1,250	1,250
FV Adj Plant	500	500
	3,900	5,900

(W3) Goodwill

	$
Fair value of consideration	3,500
FV of NCI at acquisition	1,100
	4,600
Less:	
Fair value of net assets at acquisition (W2)	(3,900)
Goodwill on acquisition	700

(W4) Non-controlling interest

	$
FV of NCI at acquisition (as in W3)	1,100
NCI share of post-acquisition reserves (W2) (25% × ($5,900 – $3,900))	500
	1,600

(W5) Group retained earnings

	$
100% P	8,300
75% of S post-acq'n retained earnings (75% × ($5,900 – $3,900))	1.500
	9.800

Test your understanding 4

Consolidated statement of financial position as at 31 Dec 20X3

Non-current assets		$000
Goodwill (W3)		28.0
Property, plant & equipment ($100 + $30)		130.0
		158.0
Current Assets		
Inventory (90 + 20 – 4 (W6))	106.0	
Receivables ($110 + $25 – $22 intra-co)	113.0	
Bank ($10 + $5)	15.0	
		234.0
		392.0
Equity and liabilities:		$000
Equity		
Share capital of $1		15.0
Group retained earnings (W5)		178.8
NCI (W4)		6.2
		200.0
Non-current liabilities ($120 + $28)		148.0
Current liabilities ($50 + $16 – $22 intra-co)		44.0
		392.0

Workings

(W1) Group structure

H
| 90%   01/01/X2
S

(W2) Net assets

	Acquisition date	Reporting date
	$000	$000
Share capital	5.0	5.0
Retained earnings	5.0	31.0
PURP (W6)		(4.0)
	10.0	32.0

(W3) Goodwill

	$000
Fair value of consideration	34.0
FV of NCI at acquisition	4.0
	38.0
Less:	
Fair value of net assets at acquisition (W2)	(10.0)
Goodwill on acquisition	28.0

(W4) Non-controlling interest

	$000
FV of NCI at acquisition (as in W3)	4.0
NCI share of post-acquisition reserves (W2)	2.2
(10% × ($32 – $10))	
	6.2

(W5) Group retained earnings

	$000
100% H	159.0
90% S post-acq'n	
(90% × ($32 – $10 (W2))	19.8
	178.8

(W6) PURP

	$000	**Percentage**
Sales	18	150
COS		100
Gross profit	6	50
	× 2/3	
	PURP = $4,000	

Test your understanding 5

Consolidated statement of financial position as at 30 Nov 20X7

	$
Non-current assets	
Goodwill (W3)	22,250
PPE ($138,000 + $115,000)	253,000
Investments ($98,000 – $76,000)	22,000
	297,250
Current Assets	
Inventory ($15,000 + $17,000 – $1,600 (W6))	30,400
Receivables ($19,000 + $20,000)	39,000
Bank	2,000
	368,650
Equity and liabilities:	
Equity:	
Equity share capital	50,000
Group retained earnings (W5)	190,550
Non-controlling Interest (W4)	52,100
	292,650
Current liabilities ($33,000 + $43,000)	76,000
	368,650

Workings

(W1) Group structure

K
| 60%
S

1 May 2007 i.e. 7 months

(W2) Net assets

	Acquisition date	Reporting date
	$	$
Equity share capital	40,000	40,000
Retained earnings	63,750	69,000
	103,750	109,000

RE @ acq'n (balance) (ß)	63,750
Post-acq profit (7/12 × $9,000)	5,250
RE @ reporting date	69,000

(W3) Goodwill

	$
Fair value of consideration	76,000
FV of NCI at acquisition	50,000
	126,000
Less:	
Fair value of net assets at acquisition (W2)	(103,750)
Goodwill on acquisition	22,250

(W4) Non-controlling interest

	$
FV of NCI at acquisition (as in W3)	50,000
NCI share of post-acquisition reserves (W2) (40% × ($109,000 – $103,750))	2,100
	52,100

(W5) Group retained earnings

	$
100% K	189,000
PURP (W6)	(1,600)
60% S post-acq'n profit (60% × ($109,000 – $103,750 (W2)))	3,150
	190,550

(W6) PURP – Inventory

Profit in inventory (25/125 × $8,000) $1,600

Test your understanding 6

Task 1:

(a) **Choose the correct calculation of goodwill upon acquisition of CRU.**

		Selected answer
(i)	\$27,000 – (\$4,000 + 6,000 + \$9,000)	
(ii)	\$27,000 – (4,000 + \$2,000)	
(iii)	\$27,000 – (\$4,000 + \$6,000 + \$2,000)	Correct

(b) **Identify which one of the following would be the correct classification for goodwill in the consolidated statement of financial position.**

		Selected answer
(i)	A non-current liability	
(ii)	An intangible non-current asset	Correct
(iii)	A tangible non-current asset	

Task 2

Complete the following table to state at what amount each of the following items should be included in the consolidated statement of financial position at 31 December 20X9.

		\$
(i)	Property, plant and equipment	86,000
(ii)	Current assets	247,000
(iii)	Equity share capital	80,000
(iv)	Share premium	20,000
(v)	Current liabilities	201,000

Task 3

What amount should be included in the consolidated statement of financial position for retained earnings as at 31 December 20X9?

\$
47,000

For reference, the completed consolidated statement of financial position is produced below with supporting workings.

Consolidated statement of financial position of DOC Group as at 31 December 20X9

	$
Non-current assets:	
Goodwill (W3)	15,000
PPE ($75,000 + $11,000)	86,000
Current assets ($214,000 + $33,000)	247,000
	348,000
Equity and liabilities:	
Equity:	
Equity capital (DOC only)	80,000
Share premium (DOC only)	20,000
Group retained earnings (W5)	47,000
	147,000
Current liabilities ($176,000 + $25,000)	201,000
	348,000

(W1) Establish the group structure

DOC

1 Jan 20X9 | 100%

CRU

(W2) Net assets of CRU

	At date of acquisition	At the reporting date
	$	$
Equity share capital	4,000	4,000
Other components of equity:		
Share premium	6,000	6,000
Retained earnings	2,000	9,000
	12,000	19,000

(W3) Goodwill

	$
Fair value of consideration	27,000
Less:	
Fair value of net assets at acquisition (W2)	(12,000)
Goodwill on acquisition	15,000

(W4) NCI

Not applicable to this example as CRU is 100% owned.

(W5) Group retained earnings

	$
DOC retained earnings (100%)	40,000
CRU – group share of post-acquisition retained earnings 100% × ($19,000 – $12,000 (W2))	7,000
	47,000

Chapter

20

Consolidated statement of profit or loss and associates

Chapter learning objectives

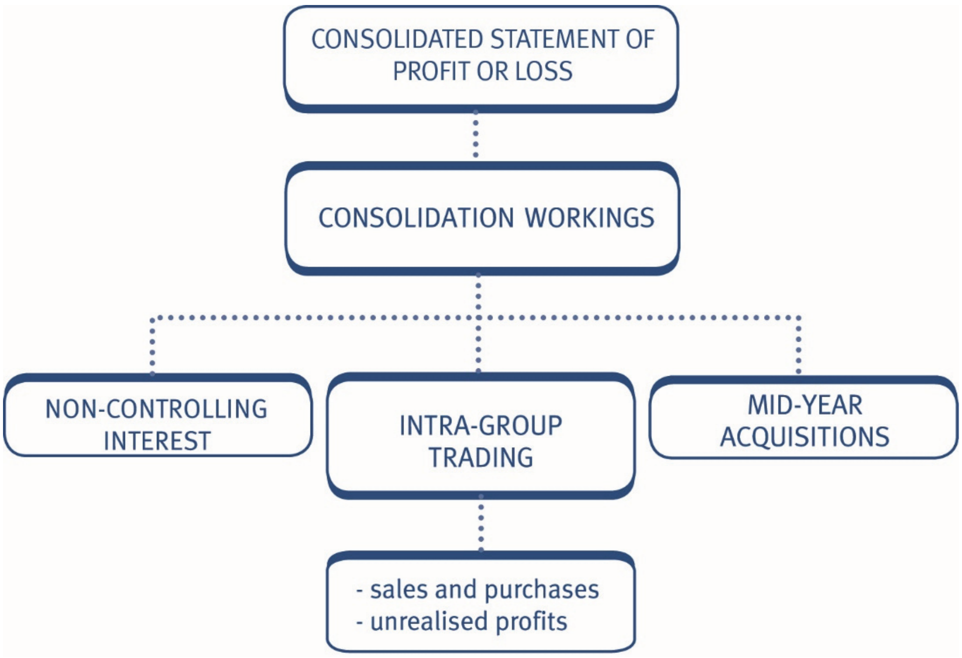
Upon completion of this chapter you will be able to

- describe the components of and prepare a consolidated statement of profit or loss or extracts thereof, including the following adjustments:
  - (i) intra-group trading
  - (ii) unrealised profit
  - (iii) mid-year acquisitions
- define and identify an associate
- describe the principle of equity accounting.

PER

One of the PER performance objectives (PO7) is to prepare and review financial statements in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.

1 Overview



Introduction

This chapter develops the content introduced in the previous chapter dealing with the preparation of consolidated accounts. In particular, it considers the preparation of a consolidated statement of profit or loss, and deals with the profit or loss perspective of many of the workings and adjustments introduced in the previous chapter. In conclusion, the chapter introduces the concept of an associate, including its definition and accounting treatment in consolidated financial statements.

The preparation of consolidated financial statements is a key topic within both Financial Reporting and Strategic Business Reporting.

2 The basic principles

The consolidated statement of profit or loss presents the financial performance of all group entities (i.e. parent and subsidiaries under common control) in one statement.

The consolidated statement of profit or loss follows the same basic principles as the consolidated statement of financial position. There are fewer adjustments, and they often reflect the profit or loss perspective of adjustments already dealt with for the consolidated statement of financial position.

The steps for consolidating the statements of profit or loss are as follows:

1 Add together the revenues and expenses of the parent and the subsidiary on a line-by-line basis and, if the subsidiary is acquired part-way through the year, time-apportion the results of the subsidiary.

2 Eliminate intra-group sales and purchases.

3 Eliminate unrealised profit held in closing inventory relating to intra-group trading.

4 Calculate the profits attributable to the non-controlling interests.

After profit for the year show split of profit between amounts attributable to the parent's shareholders and the non-controlling interest (to reflect ownership).

3 Non-controlling interest

This is calculated as:

	$
NCI % × subsidiary's profit after tax	x
Less: NCI % × PURP (when the sub is the seller only)	(x)
	x

Illustration 1

The statements of profit or loss for P and S are shown below. P acquired 75% of the equity share capital of S several years ago.

Year ended 31 August 20X4	**P**	**S**
	$000	$000
Revenue	1,200	400
Cost of sales	(1,080)	(360)
Gross profit	120	40
Administrative expenses	(75)	(30)
Profit before tax	45	10
Tax	(15)	(6)
Profit for the year	30	4

Required:

Prepare the consolidated statement of profit or loss for the year.

Solution to Illustration 1

Consolidated statement of profit or loss of P group for the year ended 31 August 20X4:

	$000
Revenue ($1,200 + $400)	1,600
Cost of sales ($1,080 + $360)	(1,440)
Gross profit	160
Administrative expenses ($75 + $30)	(105)
Profit before tax	55
Tax ($15 + $6)	(21)
Profit for the year	34
Attributable to:	
Group (bal fig)	33
Non-controlling interest (W1)	1
	34

(W1) Non-controlling interest

NCI share of subsidiary profit for the year (NCI% × sub's profit for the year)

25% × $4,000 = $1,000

4 Intra-group trading

Sales and purchases

The effect of intra-group trading must be eliminated from the consolidated statement of profit or loss. Such trading will be included in the revenue of one group entity and the purchases of the other.

- Consolidated revenue = P’s revenue + S’s revenue – intra group sales.
- Consolidated cost of sales = P’s COS + S’s COS – intra-group purchases.

5 Provision for unrealised profits

Inventory

If any goods traded between the parent and the subsidiary are included in closing inventory, their value must be adjusted to the lower of cost and net realisable value (NRV) to the group (as in the CSFP).

The adjustment for unrealised profit should be shown as an increase to cost of sales (return inventory back to true cost to group and eliminate unrealised profit).

Illustration 2 – PURP

On 1 January 20X9 P acquired 60% of the equity shares of S.

The following statements of profit or loss have been produced by P and S for the year ended 31 December 20X9.

	P	S
	$000	$000
Revenue	630	260
Cost of sales	(210)	(105)
Gross profit	420	155
Distribution costs	(90)	(30)
Administration expenses	(60)	(45)
Profit from operations	270	80
Investment income from S	18	
Profit before taxation	288	80
Tax	(65)	(13)
Profit for the year	223	67

During the year ended 31 December 20X9 P had sold goods priced at $42,000 to S. These goods had cost P $28,000. On 31 December 20X9 S still had half of these goods in inventories at the year end.

Required:

Calculate group revenue and cost of sales for the year ended 31 December 20X9.

Solution to Illustration 2

Unrealised profit in inventory

	$000
Selling price	42
Cost of goods	(28)
Total profit	14
Provision for unrealised profit: ½ × $14	7

Group revenue

This equals P's revenue + S's revenue – intragroup sales:

$630 + $260 – $42 = **$848**

Group cost of sales

This equals P's COS + S's COS – intragroup purchases + unrealised profits (this is added so that it increases costs and reduces overall group profits).

$210 + $105 – $42 + $7 = **$280**

Test your understanding 1

Required:

Prepare the consolidated statement of profit or loss of P Group for the year ended 31 December 20X9, based upon the preceding illustration.

6 Mid-year acquisitions

Mid-year acquisition procedure

If a subsidiary was acquired part way through the year, then the subsidiary's results should only be consolidated from the date of acquisition, i.e. the date on which control was acquired.

In practice this will require time apportionment of the results of S in the year of acquisition. For this purpose, unless indicated otherwise, assume that revenue and expenses accrue evenly throughout the year. Time-apportioning is normally based on a full month, rather than e.g. control acquired by P on, say, 19 August. After time-apportioning S's results, deduct post-acquisition intra-group items as normal.

Note, however, that accounting for items of other comprehensive income in the group statement of profit or loss and other comprehensive income are excluded from the syllabus. Therefore, only items affecting the group statement of profit or loss are examinable.

Illustration 3 – Mid-year acquisitions

The following statements of profit or loss have been produced by P and S for the year ended 31 March 20X9.

	P	S
	$000	$000
Revenue	151,800	108,850
Cost of sales	(71,900)	(51,100)
Gross profit	79,900	57,750
Distribution costs	(35,600)	(25,650)
Profit from operations	44,300	32,100
Investment income	1,400	600
Profit before taxation	45,700	32,700
Tax	(23,100)	(16,300)
Profit for the year	22,600	16,400

- On 1 December 20X8 P acquired 75% of the issued equity share capital of S. No dividends were paid by either entity during the year. The investment income is from listed investments and has been correctly accounted for.
- The profits of both entities are deemed to accrue evenly over the year.

Required:

Prepare the consolidated statement of profit or loss of P Group for the year ended 31 March 20X9.

Solution to Illustration 3

P consolidated statement of profit or loss for the year ended 31 March 20X9

	$000
Revenue	188,083
($151,800 + ($108,850 × 4/12))	
Cost of sales	(88,933)
($71,900 + ($51,100 × 4/12))	
Gross profit	99,150
Operating expenses	(44,150)
($35,600 + ($25,650 × 4/12))	
Profit from operations	55,000
Investment income	1,600
($1,400 + ($600 × 4/12))	
Profit before taxation	56,600
Tax	(28,533)
($23,100 + ($16,300 × 4/12))	
Profit for the year	28,067
Amount attributable to:	
Equity holders of the parent	26,700
Non-controlling interest	1,367
(25% × ($16,400 × 4/12))	
	28,067

Note:

P acquired 75% of the issued equity share capital of S on 1 December 20X8. This is the date on which control passed and hence the date from which the results of S should be reflected in the consolidated statement of profit or loss.

All reserves earned by S in the four months since that date are post acquisition reserves.

The previous eight months' profit from 1 April 20X8 to 30 November 20X9 is all pre-acquisition.

Test your understanding 2

Set out below are the draft statements of profit or loss of P and its subsidiary S for the year ended 31 December 20X7.

On 1 January 20X6 P purchased 75% of the equity shares in S.

	P	S
	$000	$000
Revenue	300	150
Cost of sales	(180)	(70)
Gross profit	120	80
Operating expenses	(47)	(23)
Profit from operations	73	57
Finance costs		(2)
Profit before taxation	73	55
Tax	(25)	(16)
Profit for the year	48	39

- During the year S sold goods to P for $20,000, making a mark-up of one third. Only 20% of these goods had been sold before the end of the year, the remainder is still in inventory.

Required:

Prepare the consolidated statement of profit or loss for the year ended 31 December 20X7.

7 IAS 28 Accounting for investments in associates and joint ventures

Key definitions relating to an associate

An associate is defined as **'an entity over which the investor has significant influence'** (IFRS 28, para 3).

Please note that joint ventures are not part the Financial Accounting syllabus.

'Significant influence is 'the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies' (IAS 28, para 3).

An **investor** is an entity which owns a shareholding in another entity. An **investee** is an entity in which another entity has a shareholding.

An investor is presumed to have significant influence over another entity when it has a shareholding in that other entity between 20% and 50% and is able to participate in management, perhaps by having representation on the board of directors.

Principles of equity accounting and reasoning behind it

Equity accounting is a method of accounting whereby the investment is initially recorded at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the associate.

The effect of this is that the consolidated statement of financial position includes:

- 100% of the assets and liabilities of the parent and subsidiary entity on a line-by-line basis
- a single 'investments in associates' line within non-current assets which includes the group share of the assets and liabilities of any associate.

The consolidated statement of profit or loss includes:

- 100% of the income and expenses of the parent and subsidiary entity on a line-by-line basis
- a single 'share of profit of associates' line which includes the group share of any associate's profit after tax.

Note: In order to equity account, the parent entity must already be producing consolidated financial statements (i.e. it must already have at least one subsidiary).

IAS 28 Investments in Associates and Joint Ventures

Accounting for associates per to IAS 28

The equity method of accounting is normally used to account for associates in the consolidated financial statements.

The equity method should not be used if:

- the investment is classified as held-for-sale in accordance with IFRS 5, or
- the parent is exempted from having to prepare consolidated accounts on the grounds that it is, itself, a wholly or partially owned subsidiary of another entity (IFRS 10).

8 Associates in the consolidated statement of financial position

Preparing the CSFP including an associate

The CSFP is prepared on a normal line-by-line basis following the acquisition method for the parent and subsidiary.

The associate is included as a one-line item as a non-current asset investment calculated as follows:

	$000
Cost of investment	X
Share of post-acquisition profits	X
Less: impairment losses	(X)
Less: group share of PURP (P = seller)	(X)
	X

The group share of the associate's post-acquisition profits or losses and any impairment of the investment in the associate will also be included in the group retained earnings calculation.

9 Associates in the consolidated statement of profit or loss

Equity accounting

The equity method of accounting requires that the consolidated statement of profit or loss:

- does not include dividends from the associate
- instead, it includes the group share of the **associate's profit after tax** less any impairment of the associate in the year (included after group profit from operations in arriving at the **group profit before tax** in the consolidated statement of profit or loss).

Trading with the associate

Generally the associate is considered to be outside the group as the investor is only able to exercise significant influence, rather than control.

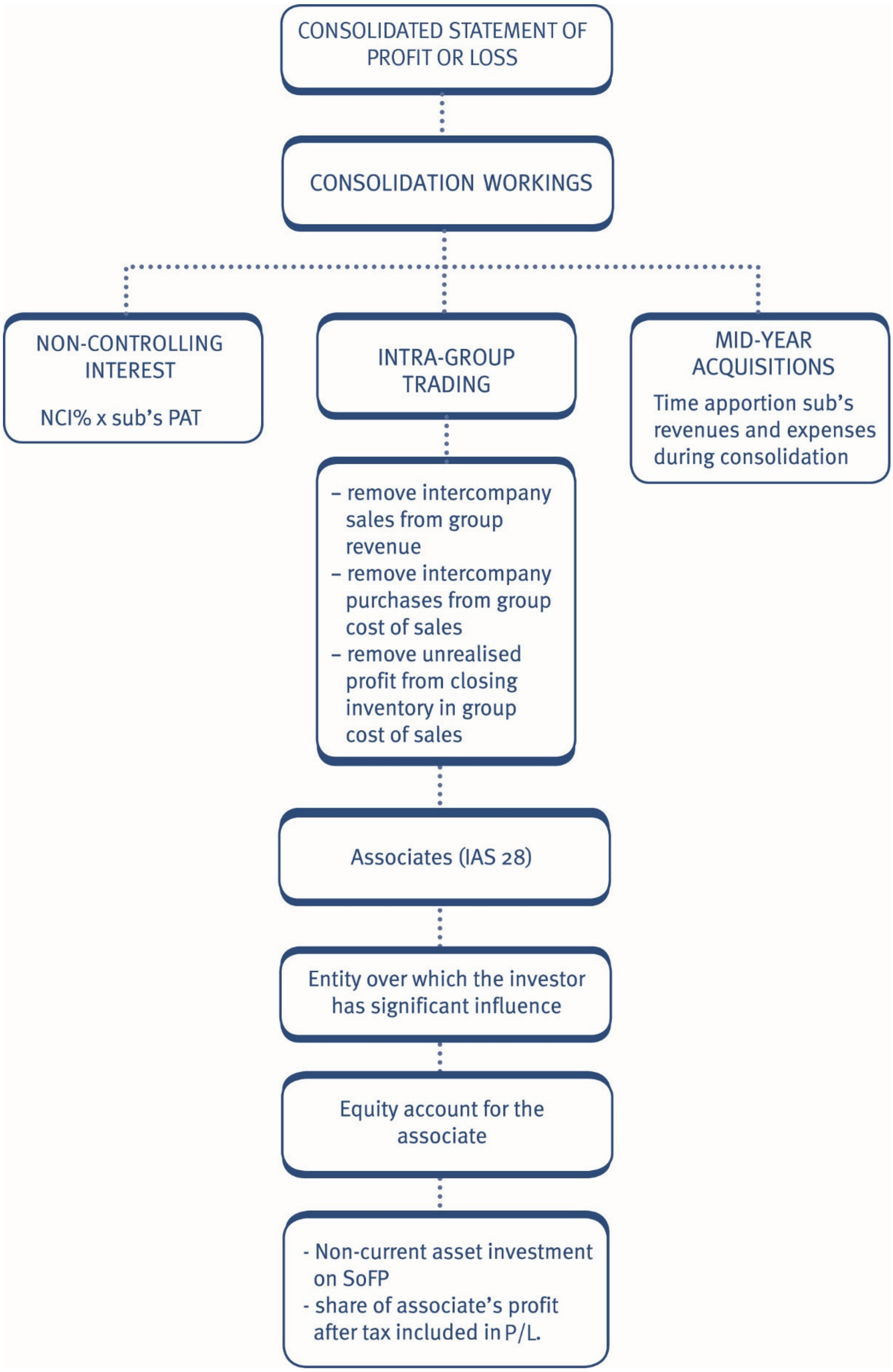
Therefore any sales or purchases between group entities (parent and subsidiaries) and the associate are not normally eliminated and will remain part of the consolidated figures in the statement of profit or loss.

Instead it is normal practice to adjust only for the group share of any unrealised profit in inventory.

Simple investments

When an entity invests in the shares of another entity but acquires neither control, nor significant influence, this is referred to as a 'simple' or 'trade' investment. In this case the investment is carried as a non-current asset in the statement of financial position and any dividends received from the investee are included in the statement of profit or loss.

10 Chapter summary



Test your understanding answers

Test your understanding 1

P consolidated statement of profit or loss for the year ended 31 December 20X9

	P
	$000
Revenue ($630 + $260 – $42)	848
Cost of sales and expenses ($210 + $105 – $42 + $7(W1))	(280)
Gross profit	568
Distribution costs ($90 + $30)	(120)
Administration expenses ($60 + $45)	(105)
Profit from operations	343
Tax ($65 + $13)	(78)
Profit for the year	265
Amount attributable to:	
Equity holders of the parent (bal fig)	238.2
Non-controlling interest (W2)	26.8
	265

(W1) Unrealised profit in inventory

	$000
Selling price	42
Cost of goods	(28)
Total profit	14
Provision for unrealised profit ½ × $14	7

(W2) Non-controlling interest

NCI share of subsidiary's profit after tax 40% × $67,000 = $26,800

Test your understanding 2

P consolidated statement of profit or loss for the year ended 31 December 20X9

	P
	$000
Revenue ($300 + $150 – $20)	430
Cost of sales and expenses ($180 + $70 – $20 + $4 (W1))	(234)
Gross profit	196
Operating expenses ($47 + $23)	(70)
Profit from operations	126
Finance costs	(2)
Profit before taxation	124
Tax ($25 + $16)	(41)
Profit for the year	83
Profit for the year – amount attributable to:	
Equity holders of the parent	74.25
Non-controlling interest (W2)	8.75
	83.00

(W1) Unrealised profit in inventory

	$000
Selling price	20.00
Cost (100/133% × $20)	(15.00)
Total profit	5.00
Provision for unrealised profit 80% × $5	4.00

(W2) Profit for the year – non-controlling interest

	$000
NCI share of subsidiary's profit after tax (25% × $39)	9.75
Less NCI share of PURP (25% × $4 (W1))	(1.00)
	8.75

Chapter

21

PRACTICE QUESTIONS

Section A: Objective Test Questions

All questions are worth two marks.

The regulatory and conceptual framework

1 **When preparing financial statements using historic cost accounting in periods of inflation, how should the preparers of the financial statements reflect this situation?**

A They must reduce asset values

B They must increase asset values

C They must reduce dividends

D They need make no adjustments

2 **If the owner of a business takes goods from inventory for own personal use, which accounting concept should be applied to record that transaction?**

A The relevance concept

B The capitalisation concept

C The money measurement concept

D The separate entity concept

3 **Which statement explains that the financial statements present a 'true and fair view'?**

A It presents the financial statements in such a way as to exclude errors which would affect the actions of those reading them

B It occurs when the financial statements have been audited

C It shows the financial statements of an entity in an understandable format

D It shows the assets on the statement of financial position at their current market value

4 **Which concept is applied when an entity records the cost of a non-current asset even though it does not legally own it?**

A Substance over form

B Prudence

C Accruals

D Going concern

5 The Framework identifies several qualitative characteristics that make financial information useful.

Which one of the following only contains qualitative characteristics of useful information contained in the Framework?

A Prudence, consistency, understandability, faithful representation, substance over form

B Accruals basis, going concern concept, consistency, prudence, true and fair view

C Faithful representation, neutrality, substance over form, completeness, consistency, faithful and free from material error

D Relevance, faithful representation, timeliness, comparability, verifiability

6 **Which is the accounting concept or convention which, in times of rising prices, tends to understate asset values and overstate profits?**

A The going concern concept

B The prudence concept

C The realisation concept

D The historical cost concept

Double-entry bookkeeping

7 **Which of the following group of statements is correct?**

A A debit entry will increase non-current assets

A debit entry will increase drawings

A debit entry will increase profit

B A credit entry will increase a bank overdraft

A debit entry will increase payables

A credit entry will increase receivables

C A debit entry will increase profit

A debit entry will increase receivables

A debit entry will decrease payables

D A debit entry will increase receivables

A credit entry will decrease non-current assets

A credit entry will increase profit

8 **What would a debit balance on a ledger account indicate?**

A It represents an amount owing to the entity

B It represents either a liability or an expense

C It represents either an asset or an expense

D It represents either a liability or revenue

9 **The double-entry system of bookkeeping normally results in which of the following balances on the ledger accounts?**

	Debit balances	**Credit balances**
A	Assets and revenues	Liabilities, equity and expenses
B	Revenues, equity and liabilities	Assets and expenses
C	Assets and expenses	Liabilities, equity and revenues
D	Assets, expenses and equity	Liabilities and revenues

10 **What is the main aim of financial accounting?**

A To maintain ledger accounts for every asset and liability

B To provide financial information to users of such information

C To produce a trial balance

D To record every financial transaction individually

11 **What could be the effect of recording a credit entry in a ledger account?**

A An increase in assets or an increase in liabilities

B An increase in expense or an increase in equity/capital

C An increase in liabilities or an increase in equity/capital

D An increase in liabilities and a decrease in sales

12 **What would a credit balance on a ledger account indicate?**

A It represents either a liability or equity/capital

B It represents a liability, or income or equity/capital

C It represents either income or a liability

D It represents either equity/capital or income

13 **When balancing-off an expense account at the end of an accounting period, how should it be treated?**

A The debit balance brought down be carried forward to the next accounting period

B The credit balance brought down will be carried forward to the next accounting period

C The closing balance will be transferred to the statement of financial position

D The closing balance will be transferred to the statement of profit or loss

14 **When balancing-off a liability account at the end of an accounting period, how should it be treated?**

A The closing balance will be transferred to the statement of financial position

B The closing balance will be transferred to the statement of profit or loss

C The credit balance brought down will be carried forward to the next accounting period

D The debit balance brought down will be carried forward to the next accounting period

Recording transactions and events

15 All the sales of G Co, a retailer, were made at a price inclusive of sales tax at the standard rate of 17.5% and all purchases and expenses bore sales tax at the standard rate. For the three months ended 31 March 20X5 gross sales were $23,500, purchases were $12,000 (net) and expenses $800 (net). There was a nil balance on the sales tax account at 1 January 20X5.

How much is due to the tax authority for the quarter?

$________

16 **Which entries would you normally expect to see in the revenue ledger account?**

A Credit entries for the total of sales made, including sales tax

B Credit entries for the total of sales made, excluding sales tax

C Debit entries for the total of sales made, including sales tax

D Debit entries for the total of sales made, excluding sales tax

17 A business had sales (including sales tax) totalling $27,612.50 for the month of July 20X6. During the same month, it had purchases (excluding sales tax) totalling $18,000. There was a nil balance on the sales tax account at 1 July 20X6.

What was the balance on the sales tax account, assuming all items are subject to sales tax at 17.5% at 31 July 20X6?

A $962.50 debit

B $962.50 credit

C $1,682.10 debit

D $1,682.10 credit

18 Andi set up a new business, introducing capital of $1,000. Inventory costing $800 net of sales tax at 17.5% was purchased on credit. Half of this inventory was then sold for $1,000 plus sales tax, the customer paying promptly.

What was the accounting equation after these transactions?

A assets $1,775 less liabilities $175 equals capital $1,600

B assets $2,775 less liabilities $975 equals capital $1,200

C assets $2,575 less liabilities $800 equals capital $1,775

D assets $2,575 less liabilities $975 equals capital $1,600

19 Manat made a purchase of goods which had a list price of $6,000, on which a trade discount ten per cent was allowed. The seller also offered Manat a ten per cent settlement discount if payment was received within ten days of the invoice date, and expected Manat to take advantage of this offer.

At what cost should this purchase initially be recorded in Manat's accounting records?

A $4,800

B $4,860

C $5,400

D $6,000

20 Chaila made a purchase of goods from Avika which had a list price of $8,000, on which a trade discount ten per cent was allowed. Avika also offered Chaila a ten per cent settlement discount if payment was received within ten days of the invoice date, and expected Chaila to take advantage of this offer.

At what value should this sale transaction initially be recorded in Avika's accounting records?

A $6,400

B $6,480

C $7,200

D $8,000

Inventory

21 Terri's business sells three products – A, B and C. The following information was available at the year-end:

	A	**B**	**C**
	$	$	$
	Per unit	**Per unit**	**Per unit**
Cost	7	10	19
Estimated selling price	15	13	20
Selling and distribution costs	2	5	6
Units of inventory	20	25	15

What should be the inventory valuation at the year-end?

$________

22 An inventory record card shows the following details:

January	1	50 units in inventory at a cost of $10 per unit
	4	90 units purchased at a cost of $15 per unit
	10	65 units sold
	20	30 units purchased at a cost of $20 per unit
	26	40 units sold

What was the value of inventory at 31 January using the first in, first out (FIFO) method?

A $1,125

B $725

C $975

D $1,000

23 **What would be the effect on an entity's profit, which has been calculated including inventory at cost, of discovering that one of its inventory items which cost $7,500 has a net realisable value of $8,500?**

A an increase of $8,500

B an increase of $1,000

C no effect at all

D a decrease of $1,000

24 **According to IAS 2 Inventories, which two of the following costs should be included in valuing the inventories of a manufacturing business?**

	Selection
Carriage outwards	
Depreciation of factory plant	
Carriage inwards	
General admin overheads	

25 The closing inventory of X Co amounted to $116,400 excluding the following two inventory lines:

– 400 items which had cost $4 each. All were sold after the statement of financial position date for $3 each, with selling expenses of $200 for the batch.

– 200 different items which had cost $30 each. These items were found to be defective at the statement of financial position date.

Rectification work after the statement of financial position amounted to $1,200, after which the items were sold for $35 each, with selling expenses totalling $300.

What was the inventory valuation to include in the statement of financial position of X Co?

$________

26 ABC Co estimated that inventory which had cost $50,000 had a net realisable value of $40,000 at 30 June 2005 and recorded it in the financial statements for the year ended 30 June 2005 at this lower value in accordance with IAS 2 Inventories. ABC Co subsequently discovered that the net realisable value of the inventory is likely to be only $30,000.

What adjustments, if any, should be made in the financial statements of ABC Co relating to this inventory?

A No adjustments required

B Increase the value of inventory by $10,000

C Decrease the value of inventory by $10,000

D Decrease the value of inventory by $20,000

Tangible non-current assets

27 At 1 January 20X5, Maz had motor vehicles which cost $15,000. On 31 August 20X5 Maz sold a motor vehicle for $5,000 which had originally cost $8,000 and which had a carrying amount of $4,000 at the date of disposal. Maz purchased a new motor vehicle which cost $10,000 on 30 November 20X5.

Maz's policy is to depreciate motor vehicles at a rate of 25% pa on the straight-line basis, based on the number of months' ownership.

What was the depreciation charge for the year ended 31 December 20X5?

$________(answer to the nearest whole number)

28 **Which of the following best explains what is meant by 'asset expenditure'?**

A expenditure on non-current assets, including repairs and maintenance

B expenditure on expensive assets

C expenditure relating to the issue of share capital

D expenditure relating to the acquisition or improvement of non-current assets

29 A non-current asset was purchased at the beginning of Year 1 for $2,400 and depreciated by 20% pa by the reducing-balance method. At the beginning of Year 4 it was sold for $1,200.

What was the profit or loss on disposal of the asset?

$________ profit/loss*

*delete which does not apply

30 Perry bought a new machine. The machine cost $100,000 and delivery and installation costs were $7,000. Testing it amounted to $5,000. Training employees on how to use the machine cost of $1,000.

What amount should Perry recognise as the cost of the machine for inclusion in the statement of financial position?

$________

31 Jo's machinery cost account showed a balance of $5,000 at 1 January 20X5. During the year Jo had the following transactions:

28 February	Disposed of machine costing $300
31 March	Acquired machine costing $1,000
1 November	Disposed of machine costing $600

Jo depreciates machines at a rate of 10% pa on the straight-line basis based on the number of months' ownership.

What was the depreciation charge in respect of machinery for the year ended 31 December 20X5?

$________

32 B Co acquired a lorry on 1 May 20X0 at a cost of $30,000. The lorry has an estimated useful life of four years, and an estimated resale value at the end of that time of $6,000. B Co charges depreciation on the straight-line basis, with a proportionate charge in the period of acquisition.

What was the depreciation charge for the lorry in B Co's financial statements for the year ended to 30 September 20X0?

$________

33 Card Co owns a warehouse. It was purchased thirty years ago for $300,000 and is depreciated on a straight-line basis over fifty years. At 1 January 20X4 when the warehouse still had an estimated useful life of twenty years, Card Co decided to revalue the warehouse to its fair value of $400,000.

What was the revaluation surplus arising upon revaluation of the warehouse?

$________

34 Card Co owns a warehouse. It was purchased thirty years ago for $300,000 and is depreciated on a straight-line basis over fifty years. At 1 January 20X4 when the warehouse still had an estimated useful life of twenty years, Card Co decided to revalue the warehouse to its fair value of $400,000. Following the decision to revalue the warehouse, Card Co decided to make the annual transfer of 'excess depreciation'.

What was amount of the annual transfer of 'excess depreciation' for the year ended 31 December 20X4?

$________

35 Card Co owns a warehouse. It was purchased thirty years ago for $300,000 and is depreciated on a straight-line basis over fifty years. At 1 January 20X4 when the warehouse still had an estimated useful life of twenty years, Card Co decided to revalue the warehouse to its fair value of $400,000. Following the decision to revalue the warehouse, Card Co decided to make the annual transfer of 'excess depreciation. Card Co disposed of the warehouse on 31 December 20X9 for $500,000.

What was profit on disposal of the warehouse for inclusion in the financial statements for the year ended 31 December 20X9?

$________profit/loss (delete which is not applicable)

Intangible assets

36 Cowper Co incurred costs of $20,000 researching new cleaning chemicals during the year ended 31 December 2005. It also incurred expenditure of $40,000 developing a new cleaning product which will not go into commercial production until next year. The development project meets the criteria specified in IAS 38 Intangible Assets.

How should these costs be treated in the financial statements of Cowper Co for the year ended 31 December 20X5?

A $60,000 should be capitalised as an intangible asset on the statement of financial position, with no amortisation charge

B $40,000 should be capitalised as an intangible asset, with an amortisation charge also made, and $20,000 should be written off as an expense

C $40,000 should be capitalised as an intangible asset and should not be amortised, and $20,000 should be written off as an expense

D $60,000 should be written off as an expense

37 **Which of the following correctly describes how research and development expenditure should be treated in accordance with IAS 38 Intangible Assets?**

A Research and development expenditure must be written off to the statement of profit or loss as incurred

B Research and development expenditure should be capitalised as an intangible asset on the statement of financial position

C Research expenditure should be written off to the statement of profit or loss; development expenditure must be capitalised as an intangible asset provided that certain criteria are met

D Research expenditure should be capitalised as an intangible asset provided that certain criteria are met; development expenditure should be written off to the statement of profit or loss

38 **Which of the following statements concerning the accounting treatment of research and development expenditure are true, according to IAS 38 Intangible Assets?**

1 If certain criteria are met, research expenditure may be recognised as an asset.

2 Research expenditure, other than asset expenditure on research facilities, should be recognised as an expense as incurred.

3 In deciding whether development expenditure qualifies to be recognised as an asset, it is necessary to consider whether there will be adequate finance available to complete the project.

4 Development expenditure recognised as an asset must be amortised over a period not exceeding five years.

5 The financial statements should disclose the total amount of research and development expenditure recognised as an expense during the period.

A 1, 4 and 5

B 2, 4 and 5

C 2, 3 and 4

D 2, 3 and 5

Accruals and prepayments

39 The electricity account for the year ended 30 April 20X5 was as follows:

	$
Electricity accrued at 1 May 20X4	250
Payments made during the year in relation to:	
Quarter ending 30 June 20X4	400
Quarter ending 30 September 20X4	350
Quarter ending 31 December 20X4	425
Quarter ending 31 March 20X5	450

What are the amounts for inclusion in the financial statements for the year ended 30 April 20X5?

	$
Amount accrued at 30 April 20X5	
P&L charge for the year ended 30 April 20X5	

40 The year end of Lansdown is 31 December. The entity pays for its electricity by a standing order of $100 per month. On 1 January 20X5 the statement from the electricity supplier showed that Lansdown had overpaid by $25. Lansdown received electricity bills for the four quarters starting on 1 January 20X5 and ending on 31 December 20X5 for $350, $375, $275 and $300 respectively.

What should be the correct amounts for electricity in Lansdown's statement of profit or loss and statement of financial position for the year ended 31 December 20X5?

	$	
Statement of profit or loss		
Statement of financial position		Accrual/prepayment*

* delete which does not apply

41 At 1 January 20X5, Mikkie had a prepayment of $200 in respect of rent. Mikkie paid $1,200 on 1 March 20X5 in respect of the year ended 28 February 20X6.

What was the charge to the statement of profit or loss in respect of rent for the year ended 31 December 20X5?

$________

42 At 31 December 2003, Tayo had accrued $240 in respect of light and heat for the quarter ending 31 December 20X3. In January 2004 Tayo discovered that there had been an under-accrual of $10.

The bills for the next four quarters were as follows (q.e. = quarter ended):

Amount	**Relating to**	**Date paid**
$260	q.e. 31 March 20X4	15 April 20X4
$220	q.e. 30 June 20X4	17 July 20X4
$210	q.e. 30 September 20X4	14 October 20X4
$230	q.e. 31 December 20X4	19 January 20X5

Tayo always accrues for expenses based on the last bill.

What was the charge to the statement of profit or loss in respect of light and heat for the 15-month accounting period ended 31 March 20X5?

$________

43 Stationery paid for during the year amounted to $1,350. At the end of the year, inventory costing $70 had been received but not yet invoiced by the supplier. At the start of the year, there was an accrual for unpaid stationery for $80.

What was the expense for stationery included in the statement of profit or loss for the year?

$________

Receivables

44 At 30 April 20X5, Gomez had a receivables balance of $50,000 and an allowance for receivables of $800. Following a review of receivables, Gomez wishes to write off an irrecoverable debt of $1,000 and increase the allowance for receivables by $1,650.

What will be the net balance included in the statement of financial position for receivables at 30 April 20X5?

$________

45 As at 31 March, Lee had receivables of $82,500. Following a review of receivables, Lee decided to write off the following irrecoverable debts:

Jak	$1,000
Les	$500
Ade	$3,250

Lee adjusted the allowance for receivables to $1,250. The current balance on the allowance for receivables account is $2,000. Lee also received $300 from a debt that had been written off at an earlier date.

What was the charge to the statement of profit or loss in respect of irrecoverable debt expense and the entry on the statement of financial position for net receivables at 31 March?

	$
Statement of profit or loss	
Statement of financial position	

46 At the start of the year Cal had an allowance of $700 against receivables. During the year, of this amount, $450 went bad and $150 was received; the balance remained unpaid at the year end. Subsequently, a further debt of $170 went bad. At the year-end Cal decided that an allowance for receivables of $340 was required.

What was the total irrecoverable debt expense for the year?

$________

47 Akira currently has a receivables balance of $47,800 and an allowance for receivables of $1,250. Akira has just received $150 in respect of half of a debt that an allowance had been made against. Akira now believes the other half of the debt to be bad and wants to write it off. Akira also wants to increase the allowance for receivables to $1,500.

What is the total charge to the statement of profit or loss in respect of these items?

$________

48 At the year end, Bao had a trade receivables balance of $100,000 and an allowance for receivables of $5,000. Bao has not yet accounted for a receipt of $500 in respect of a debt against which an allowance had previously been made or a receipt of $1,000 in respect of a debt which had been written off in the previous year. Bao wishes to reduce the allowance for receivables by $1,965.

What balances will be shown in Bao's statement of financial position at the year-end for receivables and the allowance for receivables?

	$
Receivables	
Allowance for receivables	

49 Harlow has been advised that a customer has ceased trading and that it is almost certain that the balance of $720 owed by this customer will not be recovered.

What accounting entries should Harlow make in the general ledger to record this situation?

A	Dr	Receivables	$720
	Cr	Irrecoverable debts	$720
	Being write off of irrecoverable debt		
B	Dr	Irrecoverable debts	$720
	Cr	Receivables	$720
	Being write off of irrecoverable debt		
C	Dr	Receivables	$720
	Cr	Bank	$720
	Being write off of irrecoverable debt		
D	Dr	Bank	$720
	Cr	Receivables	$720
	Being write-off of irrecoverable debt.		

50 Sam's receivables owe a total of $80,000 at the year end. These include $900 of long-overdue debts that might still be recoverable, but for which Sam has created an allowance for receivables. During the year, Sam also wrote off an amount of $1,582.

Which of the following statements best describes Sam's position regarding receivables as at the year end?

A Trade receivables of $80,000, a specific allowance of $900 and a bad debt of $1,582

B Trade receivables of $78,418, a specific allowance of $1,582 and a bad debt of $900

C Trade receivables of $80,000 and a specific allowance of $2,482

D Trade receivables of $78,418 and a specific allowance of $682

51 Jackson Co's year end is 31 December 2005. In February 2006 a major credit customer went into liquidation and Jackson Co believes that it will not be able to recover the $450,000 owed.

How should this item be treated in the financial statements of Jackson Co for the year ended 31 December 2005?

A The irrecoverable debt should be disclosed by note

B The financial statements are not affected

C An allowance for receivables should be recognised in the financial statements

D The financial statements should be adjusted to reflect the irrecoverable debt

52 A receivables' general ledger account had a closing balance of $8,500. It contained a contra with the payables' general ledger account of $400, but this had been entered on the wrong side of the two accounts.

What was the correct balance on the receivables' general ledger account?

A $7,700 debit

B $8,100 debit

C $8,400 debit

D $8,900 debit

53 **In a receivables' general ledger account, which of the following lists is composed only of items which would appear on the credit side of the account?**

A Cash received from customers, sales returns, irrecoverable debts written off, contras against amounts due to suppliers in the accounts payable ledger

B Sales, cash refunds to customers, irrecoverable debts written off

C Cash received from customers, interest charged on overdue accounts, irrecoverable debts written off

D Sales, cash refunds to customers, interest charged on overdue accounts, contras against amounts due to suppliers in the accounts payable ledger

54 On 1 January 20X5, a business had trade receivables of $22,000. As at 31 December 20X5, the business had the following information relating to the year ended 31 December 20X5:

	$
Sales for the year	120,000
Bank receipts for the year	115,000
Early settlement discount received for the year	3,000
Dishonoured cheque	9,000
Contra with the trade payables' general ledger account	6,000

What was the closing trade receivables balance after taking the information above into account?

$________

55 **Which of the following is not the purpose of a receivables general ledger account?**

A A receivables general ledger account provides a check on the arithmetic accuracy of the personal ledger

B A receivables general ledger account helps to locate errors in the trial balance

C A receivables general ledger account helps to ensure that there are no errors in the personal ledger accounts of individual customers

D The general ledger accounts help to deter fraud

Payables, provisions and contingent liabilities

56 **Which one of the following statements defines a provision in accordance with IAS 37, Provisions, contingent liabilities and contingent assets?**

A A provision is a definite future obligation

B A provision is a present obligation to transfer economic resources as a result of a past event

C A provision is an obligation that may arise at some date in the future

D A provision is the amount paid to suppliers in exchange for goods and services received

57 A former employee is claiming compensation of $50,000 from Harriot Co. The entity's solicitor has stated that the belief that the claim is unlikely to succeed. The legal costs relating to the claim are likely to be in the region of $5,000 and will be incurred regardless of whether or not the claim is successful.

How should these items be treated in the financial statements of Harriot Co?

A Provision should be made for $55,000

B Provision should be made for $50,000 and the legal costs should be disclosed by note

C Provision should be made for $5,000 and the compensation of $50,000 should be disclosed by note

D No provisions should be made but both items should be disclosed by note

58 **Which one of the following statements defines a contingent asset in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets?**

A A contingent asset is a possible asset that is under the sole control of the entity

B A contingent asset is an asset that arises from past events and which can be reliably measured

C A contingent asset is a possible asset that arises from past events and which is not wholly under the control of the entity

D A contingent asset is a possible asset which is not wholly under the control of the entity

59 IAS 37 Provisions, Contingent Liabilities and Contingent Assets specifies three criteria for the recognition of a provision in the financial statements.

Which one of the following items is not one of the three criteria?

A There will be a probable outflow of resources as a result of a past event

B The timing of any outflow of resources can be specifically identified

C A reliable estimate can be made of the amount of the obligation

D There is a present obligation as a result of a past event

60 **Which one of the following statements best defines a contingent liability in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets?**

A A contingent liability is a present obligation that can be reliably measured

B A contingent liability is a possible obligation that arises from past events and which is under sole control of the entity

C A contingent liability is a present obligation for which a future outflow of resources is not required

D A contingent liability is a possible obligation that arises from past events and which is not wholly or partly under the control of the entity

61 On 1 January 20X5, an entity had trade payables of $33,600. As at 31 December 20X5, the entity had the following information relating to the year ended 31 December 20X5:

	$
Purchases the year	140,000
Bank payments for the year	123,500
Discounts received	3,700
Contra with the trade receivables' general ledger account	8,700

What was the closing trade payables' ledger account balance after taking the information above into account?

$________

62 On 31 May 20X7, an entity had trade payables of $50,200. As at 1 June 20X6 it had trade payables of $49,200, the entity had the following information relating to the year ended 31 May 20X7:

	$
Bank payments for the year	146,500
Contra with the trade receivables' general ledger account	4,800
Returns outwards	5,400
Discounts received	6,200

What was the cost of purchases made during the year?

$________

Capital structure and finance costs

63 Geese Co's trial balance shows an overprovision in respect of income tax for the year ended 31 December 2004 of $5,000. Geese Co estimates that tax liability in respect of the year ended 31 December 2005 will be $23,000.

What is the tax charge in Geese Co's statement of profit or loss and the liability included in the statement of financial position for the year ended 31 December 2005?

	$
Profit or loss charge	
Statement of financial position	

64 An entity has the following share capital:

	Authorised	**Issued**
	$000	$000
25c equity shares	8,000	4,000
6% 50c irredeemable preference shares	2,000	1,000

In addition to providing for the year's irredeemable preference dividend, an ordinary dividend of 2c per share is to be paid before the year end.

What was the total dividend payment for the year?

A $140,000

B $380,000

C $440,000

D $760,000

65 **What are the accounting entries required to record the issue of 100,000 50c shares (fully paid) at an issue price of $2.50 a share?**

			$	$
A	Dr	Bank	250,000	
	Cr	Share capital		100,000
	Cr	Share premium		150,000
B	Dr	Bank	250,000	
	Cr	Share capital		50,000
	Cr	Share premium		200,000
C	Dr	Bank	50,000	
	Cr	Share capital		50,000
	Cr	Share premium		
D	Dr	Bank	100,000	
	Cr	Share capital	150,000	
	Cr	Share premium		250,000

66 **Which statement best defines retained earnings?**

A Accumulated and undistributed profits of an entity

B Amounts which cannot be distributed as dividends

C Amounts set aside out of profits to replace revenue items

D Amounts set aside out of profits for a specific purpose

67 On 1 April 2004 the balance on B Co's retained earnings was $50,000 credit. The balance on that account at 31 March 2005 was $100,000 credit. On 10 March 2005 dividends of $50,000 were declared in respect of the year ended 31 March 2005, payable on 31 May 2005.

Based on this information, what was B Co's profit after tax for the year ended 31 March 2005?

$________

Reconciliations

68 At 31 August 2005 the balance on an entity's bank ledger account was $3,600 credit. An examination of the bank statements revealed the following:

– direct debits amounting to $180 had not been recorded in the bank ledger account

– payments made to suppliers of $1,420 have not yet appeared on the bank statements.

What was the balance on the bank statement at 31 August 2005?

A $5,200 overdrawn

B $5,020 overdrawn

C $2,360 overdrawn

D $3,780 overdrawn

69 The following information relates to a bank reconciliation.

(i) The credit balance on the bank ledger account was $5,670 before taking the following items into account.

(ii) Bank charges of $250 on the bank statement have not been entered in the bank ledger account.

(iii) The bank has credited the account in error with $40 which belongs to another customer.

(iv) Cheque payments totalling $325 have been correctly entered in the bank ledger account but have not yet been presented for payment.

(v) Cheques received from customers totalling $545 were correctly entered on the debit side of the bank ledger account but have not been paid in at the bank.

What was the balance as shown by the bank statement before taking the items above into account?

A $5,670 overdrawn

B $5,600 overdrawn

C $5,740 overdrawn

D $6,100 overdrawn

70 An Lee Co had an opening balance of $485 credit on its bank ledger account. The following transactions then took place:

– cash sales $1,450 including sales tax of $150 were made

– receipts from credit customers of $2,400 were received

– payments to payables to settle amounts due of $1,800 less 5% cash discount

– dishonoured cheques from credit customers amounted to $250.

What was the resulting balance in the bank ledger account?

$________ debit/credit*

*delete which does not apply

71 The bank ledger account of Asuka shows a balance of $5,675 overdrawn at 31 March 20X5. It is subsequently discovered that a standing order for $125 had been entered twice and that a dishonoured cheque for $450 had been debited in the bank ledger account instead of credited.

What was the correct bank ledger account balance at 31 March 20X5?

A $5,100 overdrawn

B $6,000 overdrawn

C $6,250 overdrawn

D $6,450 overdrawn

72 A bank reconciliation was prepared for Q Co as follows:

	$
Overdraft per bank statement	38,600
Add: deposits not yet credited	41,200
	79,800
Less: outstanding cheques	3,300
Overdraft per bank ledger account	76,500

Assuming that the bank statement balance was correct, what was Q Co's the bank ledger account balance?

$________ cash at bank/overdrawn*

*delete which does not apply

73 **After checking a business bank ledger account against the bank statement, which of the following items could require an entry in the bank ledger account?**

1 Bank charges

2 A dishonoured cheque from a customer

3 Cheques not yet presented

4 Deposits not yet credited

5 Credit transfer included in the bank statement

6 Standing order included in the bank statement.

A 1, 2, 5 and 6

B 3 and 4

C 1, 3, 4 and 6

D 3, 4, 5 and 6

74 A supplier issues a statement to a customer showing a balance outstanding of $14,350. The customer's own records show a balance outstanding of $14,500.

Which of the following statements could explain this difference?

A The supplier sent an invoice for $150 which the customer has not yet received and processed

B The supplier has allowed the customer $150 cash discount which has no yet been recorded by the customer

C The customer has paid the supplier $150 which the supplier has not yet accounted for

D The customer has returned goods of $150 which the supplier has not yet accounted for

Correction of errors and suspense accounts

75 Faulty goods costing $210 were returned by Haruka to the supplier. Haruka recorded this as $120 in the general ledger accounts.

State the accounting entries required for Haruka to correct the error.

	Ledger Account:	$
Debit		
Credit		

76 Midori started in business as a florist on 1 April 20X4. For the first six months to 30 September 20X4, Midori had a draft profit of $12,355.

On investigation you discover the following:

– rent paid for the 12 months ending 31 March 20X5, of which $800 had not been recorded in the accounting records

– closing inventory in the accounts at a cost of $1,000 had a net realisable value of $800.

What was the adjusted profit for the period?

$________

77 Tayo's draft accounts for the year ended 31 July 20X8 had a profit of $36,834.

On investigation Tayo discovered the following:

– a contra for $1,125 between the receivables and payables general ledger accounts had not been recorded

– the fixtures and fittings depreciation charge amounting to $870 had not yet been accounted for.

What was the adjusted profit for the period?

$________

78 An entity, Y Co, purchased an item of plant on 1 January 20X0 for $38,000. Although the payment for the plant had been correctly accounted for, it was treated as a repairs and renewals expense the general ledger. Y Co charges depreciation using the straight-line basis at 20% pa, with a proportionate charge in the year of acquisition and assuming no scrap value at the end of the life of the asset.

How will Y Co's profit for the year ended 31 March 20X0 be affected by the error?

A Understated by $30,400

B Understated by $36,100

C Understated by $38,000

D Overstated by $1,900

79 Mylee's draft accounts for the year ended 31 October 20X5 had a loss of $26,834.

On investigation Mylee discovered the following:

– a debt due of $750 should be written off as irrecoverable

– the allowance for receivables should be reduced from $2,350 to $1,980 the fixtures and fittings depreciation charge amounting to $870 had not yet been accounted for.

What was the adjusted result for the year?

$________ profit/loss* *delete which does not apply

80 Maz Co made a rights issue of shares, raising $50,000 on the issue of 40,000 ordinary shares with a nominal value of $1 per share and posted the premium on issue to revaluation surplus.

State the accounting entries required for Maz Co to correct the error.

	Ledger Account:	$
Debit		
Credit		

81 Pegasus Co revalued its premises to $125,000 on 31 July 20X6. The premises had cost $100,000, on which there was accumulated depreciation of $18,000 at the date of the revaluation. Pegasus Co accounted for the revaluation as follows:

Debit Premises $25,000, Credit Revaluation surplus $25,000

State the accounting entries required that Pegasus Co should make to correctly account for the premises revaluation.

	Ledger Account:	$
Debit		
Credit		

82 Castor Co disposed of a machine on 30 November 20X7 in part-exchange for a new machine. A part-exchange allowance of $4,800 had been agreed for the old machine. At that date, the cost and accumulated profit of the machine were $35,000 and $29,400 respectively. Castor Co was unsure how to account for the part-exchange allowance, and therefore did not made the following accounting entries relating to the part-exchange value.

Debit Plant and equipment $4,800 Credit Suspense $4,800

State the accounting entries required that Pegasus Co should make to correctly account for the part-exchange value of the machine.

	Ledger Account:	$
Debit		
Credit		

Preparing basic financial statements – Q&A ok from here

83 **Which one of the following correctly states the accounting equation?**

A Assets – Liabilities + Share Capital = Retained Earnings

B Assets = Liabilities – Capital + Retained Earnings

C Assets – Liabilities – Capital = Retained Earnings

D Assets + Liabilities = Capital + Retained Earnings

84 **With regard to the published statement of profit or loss which one of the following statements is true?**

A It presents an entity's financial position

B It includes dividends paid

C It presents the entity's financial performance

D It presents the entity's financial results for only one year

85 **Which one of the following choices is included in the statement of financial position of an entity?**

A Share capital, retained earnings, assets and liabilities

B Share capital, dividends paid, revenue and assets

C Assets, liabilities, profit on disposals of non-current assets and share capital

D Dividends paid, assets, discounts and liabilities

86 **Which one of the following statements is incorrect?**

A The statement of financial position and statement of profit or loss form part of the financial statements of an entity

B The statement of financial position presents the accounting equation

C The statement of profit or loss presents the accounting equation

A The statement of financial position and statement of profit or loss present the financial position and performance of the entity

87 **Which one of the following statements is not true?**

A Inventory is shown on the statement of profit or loss and in the statement of financial position

B Expenses should be included on the statement of profit or loss

C Inventory should be included on the statement of financial position only

D Receivables are included in current assets in the statement of financial position

The following is the extract of Subin's trial balance as at 31 December 20X5:

	Dr	**Cr**
	$	$
Buildings	580,000	
Buildings accumulated depreciation		116,000
Plant and machinery	50,000	
Plant and machinery accumulated depreciation		12,500
Receivables	25,800	
Allowance for receivables		1,900
Rent	34,000	
Insurance	30,000	
Irrecoverable debts	1,800	

The following notes are provided:

(i) Buildings are depreciated at 2% pa on a straight-line basis.

(ii) Plant and machinery is depreciated at 25% pa on a reducing balance basis.

(iii) Additional irrecoverable debts of $3,200 were discovered at the year-end which need to be written off. It was also decided to have an allowance for receivables of $1,130 at the year end.

(iv) The monthly rental charge is $3,000.

(v) The insurance charge for the year is $24,000.

Use the above information to attempt questions 88 to 91 inclusive.

88 **What was the depreciation charge for buildings for the year and their carrying amount at 31 December 20X5?**

Depreciation charge	$
Carrying amount	$

89 **What was the depreciation charge for plant and machinery for the year and the carrying amount at 31 December 20X5?**

Depreciation charge	$
Carrying amount	$

90 **What was the total irrecoverable debt expense for the year and the closing net receivable balance at 31 December 20X5?**

Irrecoverable debt expense	$
Carrying amount	$

91 **What was the charge for rent and insurance for the year and the closing accrual and prepayment at 31 December 20X5?**

	Charge for the year		Closing accrual/prepayment	
		$		$
A	Rent	30,000	Rent accrual	3,000
	Insurance	24,000	Insurance prepayment	6,000
B	Rent	36,000	Rent accrual	2,000
	Insurance	24,000	Insurance prepayment	6,000
C	Rent	36,000	Rent accrual	3,000
	Insurance	24,000	Insurance prepayment	6.000
D	Rent	30,000	Rent accrual	3,000
	Insurance	30,000	Insurance prepayment	6,000

92 **Which accountancy body issues IFRS Standards?**

A The Auditing Practices Board

B The Stock Exchange

C The International Accounting Standards Board

D The government

93 **Which of the following items are non-adjusting items in accordance with IAS 10 *Events after the reporting period*?**

(a) The issue of new share or loan capital.

(b) Financial consequences of losses of non-current assets or inventory as a result of fires or floods.

(c) Information regarding the value of inventory sold at less than cost thus resulting in a reduction in the value of inventory.

(d) Mergers and acquisitions.

(e) Bankruptcy of a credit customer.

A (a), (b) and (d)

B (c) and (e)

C (a), (d) and (e)

D (b), (c) and (e)

94 IAS 10 Events after the Reporting Period regulates the extent to which events after the reporting period date should be reflected in financial statements.

Which of the following lists of such events consists only of items that, according to IAS 10 *Events after the reporting period* should normally be classified as non-adjusting?

A Insolvency of a receivable whose account receivable was outstanding at the statement of financial position date, issue of shares or loan notes, a major merger with another entity

B Issue of shares or loan notes, changes in foreign exchange rates, major purchases of non-current assets

C A major merger with another entity, destruction of a major non-current asset by fire, discovery of fraud or error which shows that the financial statements were incorrect

D Sale of inventory giving evidence about its value at the statement of financial position date, issue of shares or loan notes, destruction of a major non-current asset by fire

95 **In accordance with IFRS 15, *Revenue from contracts with customers*, when should revenue be recognised if a service is provided to a customer?**

A At a point in time when service delivery is complete

B At a point in time as agreed between the service provider and the customer

C At a point in time when service delivery commences

D Over time, to match with the time period that the service is delivered

Incomplete records

96 Subin established Spark Co on 1 January 2005. Subin purchased the entire share capital of the entity in exchange for $7,600 cash. With the cash received, Spark Co acquired the following assets:

Van	$2,000
Inventory	$1,000
Receivables	$500
Prepaid insurance for inventory	$100

At the end of its first year of trading, Spark Co had the following assets and liabilities:

Van	$1,800
Fixtures	$500
Inventory	$840
Receivables	$600
Payables	$400
Bank	$3,400

What was Spark Co's profit or loss for the year?

$________ profit/loss*

* delete which does not apply

97 An entity had net assets of $10,000 at the start of the year. At the end of the year's trading the entity had earned a profit of $5,000 and had the following assets and liabilities:

Non-current assets	$20,000
Current assets	$15,000
Current liabilities	$8,000

During the year the entity paid dividends of $2,000.

How much share capital was issued during the year?

$________

98 **If Jisu normally earns a mark-up on cost of sales of 15%, what is the gross profit margin earned on sales?**

A 12.5%

B 13.04%

C 15%

D 17.65%

99 An entity had opening net assets of $10,000 and closing net assets of $4,500. During the period the entity issued $4,000 new share capital and paid dividends of $8,000.

What was the profit or loss for the accounting period?

A $9,500 loss

B $1,500 loss

C $7,500 profit

D $17,500 profit

100 **Based upon the information available below, what was the cost of purchases made during the accounting period?**

	$
Opening payables	142,600
Payments made	542,300
Discounts received	13,200
Goods returned	27,500
Closing payables	137,800

$________

101 Siwon owns a shop. The only information available for the year ended 31 December 2005 is as follows:

Inventory at 1 January 2005	$3,500
Inventory at 31 December 2005	$1,350
Sales	$17,000
Gross profit margin	25%

What were the purchases of the shop for the year?

A $11,450

B $12,750

C $14,900

D $10,600

102 The following information is relevant to the calculation of the sales figure for Alpha, a sole trader who does not keep proper accounting records:

	$
Opening receivables	29,100
Cash received from credit customers and paid into the bank	381,600
Expenses paid out of cash received 6,800 from credit customers before banking	6,800
Irrecoverable debts written off	7,200
Refunds to cash customers	2,100
Contra with payables general ledger account	9,400
Cash sales	112,900
Closing receivables	38,600

What figure should be included in Alpha's statement of profit or loss for revenue?

$________

103 A sole trader who does not keep full accounting records wishes to calculate revenue for the year.

The information available is:

1	Opening inventory	$17,000
2	Closing inventory	$24,000
3	Purchases	$91,000
4	Standard gross profit percentage	40% on sales revenue

What was the revenue figure for the year based upon the available information?

$________

104 An entity compiling its accounts for the year to 31 January each year pays rent quarterly in advance on 1 January, 1 April, 1 July and 1 October each year. After remaining unchanged for some years, the rent was increased from $24,000 per year to $30,000 per year as from 1 July 20X0.

Which of the following figures is the rent expense which should appear in the statement of profit or loss for the year ended 31 January 20X1?

A $27,500

B $29,500

C $28,000

D $29,000

105 On 31 December 20X0 the inventory of V Co was completely destroyed by fire. The following information is available:

1 Inventory at 1 December 20X0 at cost $28,400.

2 Purchases for December 20X0 $49,600.

3 Sales for December 20X0 $64,800.

4 Standard gross profit percentage on sales revenue 30%.

Based upon this information, what was the cost of the inventory destroyed?

$________

Statement of cash flows

106 In the year ended 31 December 20X5, Lamb bought new vehicles from Warwick Motors with a list price of $100,000 for an immediate payment of $70,000 and an allowance against old motor vehicles of $30,000. The value of the vehicles taken in part exchange was $27,000.

During the year ended 31 December 20X5, Lamb sold vehicles with a carrying amount of $12,000 for $15,000 cash.

In Lamb's statement of cash flows for the year ended 31 December 20X5, how would the above transactions be presented under the heading 'Investing activities'?

	Cash inflow	Cash outflow
A	–	$76,000
B	$45,000	$100,000
C	$15,000	$70,000
D	$15,000	$100,000

107 At 31 December 20X4, Topaz Co had provided $50,000 in respect of income tax. At 31 December 20X5, the entity estimated that its income tax bill in respect of the year would be $57,000. The amount charged in the statement of profit or loss for the year ended 31 December 20X5 in respect of income tax was $60,000.

How much will appear in the statement of cash flows for the year ended 31 December 20X5 relating to income tax?

A $50,000

B $53,000

C $57,000

D $60,000

108 Kiran Co had the following balances in its statement of financial position as at 30 June 20X5 and 20X4:

	20X5	**20X4**
	$	$
Current liabilities		
Taxation payable	800	400
Dividends (declared before the year-end)	3,300	2,500
Non-current liabilities		
8% Loan notes	50,000	40,000
Equity	85,500	45,500

In the year ended 30 June 20X5, income tax of $550 was paid. The additional loan notes were issued on 30 June 20X5.

What was Kiran Co's profit before tax for the year ended 30 June 20X5?

$________

109 Evan Co had the following balances in its statement of financial position as at 30 June 20X5 and 20X4:

	20X5	**20X4**
10% Loan notes	$130,000	$150,000
Share capital	$120,00	$100,000
Share premium	$45,000	$35,000

How much will appear in the statement of cash flows for the year ended 30 June 20X5 under the heading of 'Financing activities'?

$________

The following information relates to Questions 110 and 111.

Scent Co had the following balances in its statement of financial position as at 30 September 20X5 and 20X4:

	20X5	**20X4**
Loan interest accrual	$3,000	$5,000
Approved ordinary dividends	$25,000	$20,000
10% Loan notes	$100,000	$100,000
Ordinary share capital	$150,000	$150,000
8% Preference share capital	$50,000	$50,000

110 **How much will appear in the statement of cash flows for the year ended 30 September 20X5 for the loan interest and preference dividend paid?**

$________

111 **How much will appear in the statement of cash flows for the year ended 30 September 20X5 for the ordinary dividend paid?**

$________

112 IAS 7 *Statement of cash flows* requires that the statement of cash flows prepared using the indirect method to include the calculation of net cash from operating activities.

Which of the following lists consists only of items which could appear in such a calculation?

A Depreciation, increase in receivables, decrease in payables, proceeds of sale of plant

B Increase in payables, decrease in inventories, profit on sale of plant, depreciation

C Increase in payables, depreciation, decrease in receivables, proceeds of sale of plant

D Depreciation, interest paid, equity dividends paid, purchase of plant

Interpretation of financial statements

The following information relates to Questions 113 and 114.

	20X6	**20X5**
	$m	$m
Statement of profit or loss (extracts)		
Operating profit	600	410
Profit before tax	550	360
Statement of financial position (extracts)		
Issued share capital	2,000	1,500
10% loan notes	500	500

113 **What was the return on capital employed for 20X6 and 20X5?**

	20X6	**20X5**
A	24.0%	20.5%
B	30.0%	27.3%
C	22.0%	18.0%
D	27.5%	24.0%

114 **What is the total gearing for 20X6 and 20X5? (Use the debt as a percentage of total capital employed method.)**

	20X6	**20X5**
A	20%	33.3%
B	25%	25%
C	80%	75%
D	20%	25%

115 **From the following information regarding the year to 31 August 20X6, what is the payables payment period?**

	$
Sales	50,000
Cost of sales	40,000
Opening inventory	6,000
Closing inventory	3,800
Payables at 31 August 20X6	4,750

________ days

116 **From the following information regarding the year to 31 March 20X6, what are the current and quick ratios?**

	$
Inventory	5,320
Receivables	10,420
Bank at bank	3,200
Payables	4,100
Overdraft	3,121

	Current ratio	**Quick ratio**
A	2.62	1.89
B	2.62	3.84
C	3.86	2.56
D	4.62	3.32

117 For the year ended 31 December 20X8, an entity made sales of $260,000 and purchases of $150,000. At 1 January 20X8, inventory was stated at $22,000, and closing inventory at 31 December 20X8 was $26,000.

What was inventory turnover for the year?

A 5.6 times

B 10 times

C 7 times

D 10.8 times

118 During the year ended 31 March 20X2, an entity made credit sales of $460,000 and $20,000 cash sales. At 31 March 20X2, it had trade receivables $35,250.

Based upon the available information, what was the average trade receivables' collection period?

________days (to the nearest whole number)

119 During the year ended 31 July 20X2, an entity made credit purchases of $850,000 plus a further $60,000 cash purchases. At 31 July 20X2, it had trade payables of $70,000.

Based upon the available information, what was the average time taken before payment was made of trade payables?

________days (to the nearest whole number)

120 At 1 September 20X4, an entity had inventories valued at $81,000. During the year ended 31 August 20X4, it made cash and credit purchases totalling $958,000. At 31 August 20X5, the entity had inventories valued at $77,000.

Based upon the available information, as at 31 August 20X5 what was the average time that inventories are held before sale?

________days (to the nearest whole number)

Consolidated statement of financial position

121 At 1 January 20X2 Y Co acquired 75% of the share capital of Z Co for $400,000. At that date the equity capital of Z Co consisted of 600,000 ordinary shares of 50c each and its other components of equity were $50,000.

The fair value of Z Co's non-controlling interest at the date of acquisition was $100,000.

In the consolidated statement of financial position of Y Co and its subsidiary Z Co at 31 December 20X6, what amount should appear for goodwill?

A $150,000

B $137,500

C $55,000

D $110,000

122 Skinny Co acquired 75% of the equity capital Coltart Co for $35,000 on 1 January 20X4. Details of the equity share capital and other components of equity of Skinny Co and Coltart Co at 31 December 20X6 were as follows:

	Skinny Co	**Coltart Co**
	$	$
Share capital	50,000	20,000
Other components of equity	40,000	15,000

At the date of acquisition Coltart had other components of equity of $10,000.

What figure should appear in the consolidated statement of financial position of Skinny Co and its subsidiary Coltart Co for group retained earnings as at 31 December 20X6?

$________

123 Austen Co acquired 60% of the equity capital of Dicken Co for $300,000 on 1 January 20X5. Details of the equity share capital and other components of equity of Austen Co and Dicken Co at 31 December 20X6 are as follows:

	Austen Co	Dicken Co
	$	$
Equity share capital	300,000	200,000
Other components of equity	200,000	75,000

At the date of acquisition Dicken Co had other components of equity of $60,000. The fair value of the non-controlling interest in Dicken Co at acquisition was $80,000.

What figure should appear in the consolidated statement of financial position of Austen Co and its subsidiary Dicken Co for group retained earnings as at 31 December 20X6?

$________

124 At 1 January 20X5 Purves Co acquired 80% of the equity share capital of Trollope Co for $100,000. At that Trollope Co had equity share capital of 50,000 $1 shares and other components of equity of $30,000. At 31 December 20X6 the other components of equity of Purves Co and Trollope Co were as follows:

	Purves Co	Trollope Co
	$	$
Other components of equity	400,000	50,000

At the date of acquisition, the fair value of non-controlling interest in Trollope Co was $75,000.

What figure should appear in the consolidated statement of financial position of Purves Co and its subsidiary Trollope Co, for non-controlling interest?

$________

125 At 1 January 20X3 Y Co acquired 80% of the share capital of Z Co for $750,000. At that date the share capital of Z Co consisted of 600,000 ordinary shares of $1 each and its reserves were $50,000.

At the date of acquisition, the fair value of non-controlling interest in Z Co was valued at $150,000.

In the consolidated statement of financial position of Y Co and its subsidiary Z Co at 31 December 20X6, what amount should appear for goodwill?

$________

126 **Which of the following statements regarding the method of consolidation is true?**

1 Subsidiaries are equity accounted

2 Associates are consolidated in full

A Neither statement

B Statement 1 only

C Both statements

D Statement 2 only

127 **Which of the following statements are true?**

1 An associated undertaking is when a parent has control over the associate

2 Associates are equity accounted

3 Subsidiaries are consolidated in full

4 An associate is a non-controlling interest

A All of the above

B Statement 2 and 3 only

C None of the above

D Statement 1 only

128 P Co recently acquired a 60% interest in the 10,000 ordinary shares of S Co. To acquire the shareholding, P Co made an immediate payment of $2 per share acquired, along with a share exchange of 2 shares issued for every five shares acquired. At the date of acquisition, the fair value of a $1 ordinary share in P Co was $3 and the fair value of a $1 ordinary share in S Co was $4.

What was the fair value of consideration paid by P Co to acquire S Co?

$________

129 P Co recently acquired an 80% interest in the 30,000 ordinary shares of S Co. The consideration provided by P Co consisted of an immediate payment of $2.50 per share acquired, along with a share exchange of 5 shares issued for every three shares acquired. At the date of acquisition, the fair value of a $1 ordinary share in P Co was $4 and the fair value of a $1 ordinary share in S Co was $2.

What was the fair value of consideration paid by P Co to acquire S Co?

$________

Consolidated statement of profit or loss

130 X Co has owned 60% of the equity share capital of Y Co and 40% of the equity share capital of Z Co for many years. The statement of profit or loss of the three entities showed the following revenue for the year ended 31 August 20X7:

	$m
X Co	16
Y Co	8
Z Co	7

During the year X Co sold goods to Y Co and Z Co for $2 million and $1 million respectively. All goods were sold on to third parties by Y Co and Z Co by the end of the year.

How much will be included in the consolidated statement of profit or loss of the X Co group for revenue for the year ended 31 August 20X7?

$________million

131 Sat Co is the sole subsidiary of Shindo Co. The cost of sales figures for 20X1 for Sat Co and Shindo Co were $11 million and $10 million respectively. During 20X1 Shindo Co sold goods which had cost $2 million to Sat Co for $3 million. Sat Co has not yet sold any of these goods.

What is the consolidated cost of sales figure for 20X1?

$________million

132 Crunchy Co acquired 70% of the ordinary share capital of Nut Co six years ago. The following information relates to Nut Co for the year ended 30 June 20X3:

	$
Sales revenue	600,000
Cost of sales	338,000
Distribution costs	113,000
Taxation	38,000

What is the profit attributable to the non-controlling interest in the consolidated statement of profit or loss?

A $33,300

B $78,750

C $45,000

D $77,700

133 K Co acquired 60% of the ordinary share capital of Special Co five years ago. The following information relates to Special Co for the year ended 30 September 20X3:

	$
Sales revenue	960,000
Cost of sales	540,000
Administration expenses	180,000
Taxation	60,000

What is the profit attributable to the non-controlling interest in the consolidated statement of profit or loss?

$________

134 P Ltd acquired 60% of the ordinary shares of S Ltd several years ago when the reserves of S stood at $980. In the year ended 31 July 20X7 P sold goods to S for $600. The goods had been initially purchased by P for $500. At the reporting date half of those goods still remained in inventory.

What will be the provision for unrealised profit adjustment for the year ended 31 July 20X7, for the P group?

A Deduct $500 from the cost of sales

B Deduct $50 from the cost of sales

C Add $50 to the cost of sales

D Add $100 to the cost of sales

135 P Co acquired 80% of the ordinary shares of S Co several years ago. During the year ended 31 March 20X7, S Co made a profit after tax of $25,000. During the year ended 31 March 20X7 S Co sold goods to P Co for $900, which included a mark-up of 50%. At the reporting date only one-third of those goods had been sold by P Co.

What was the non-controlling interest share of the consolidated profit after tax for the year ended 31 March 20X7?

$________

Section B: Multi-task Questions (MTQ)

1 **Symmetry Co**

Symmetry Co's trial balance as at 31 December 20X1, together with supporting information, is presented below.

	Dr	Cr
	$	$
Revenue		404,000
Purchases	140,000	
Administrative expenses	105,000	
Distribution expenses	54,000	
Plant and machinery – cost	120,000	
Plant and machinery – accumulated depreciation at 1 January 20X1		35,000
Trade receivables	30,500	
Allowance for receivables – 1 January 20X1		3,000
Inventory – 1 January 20X1	16,000	
Share capital		3,000
Trade payables		24,000
Retained earnings – 1 January 20X1		7,000
6% Loan (20X3)		100,000
Income tax	1,000	
Bank	110,500	
Returns inwards	1,000	
Returns outwards		2,000
	578,000	578,000

The following notes are relevant to the preparation of the financial statements for the year ended 31 December 20X1:

(i) The current year tax liability has been estimated at $5,000.

(ii) Trade receivables include $2,000 which is now considered irrecoverable. The allowance for receivables needs to be increased to $4,000.

(iii) The cost of inventory as at 31 December 20X1 was $14,000. This included a damaged item of inventory which cost $100. It can be sold for $130 if repaired. These repairs will cost $40.

(iv) No interest has been accrued on the loan, which was taken out on 1 September 20X1.

(v) Plant and machinery is depreciated on a reducing balance basis at the rate of 10%. Depreciation is charged to cost of sales.

Required:

Task 1

(a) **'Drag and drop' the following two items to identify in which statement of profit or loss heading they should be included.**

Items: Returns inwards/ Returns outwards

(2 marks)

	Selection
Revenue	
Cost of sales	
Distribution expenses	
Administrative expenses	

(b) **What is the depreciation charge to be included in the statement of profit or loss for the year? (2 marks)**

$______

(c) **At what valuation should closing inventory be included in the financial statements for the year ended 31 December 20X1? (2 marks)**

$______

Task 2

(a) **Which of the following correctly calculates the figure to include in the statement of financial position for net trade receivables? (2 marks)**

	Selection
$30,500 – $2,000	
$30,500 – $2,000 – $4,000	
$30,500 + $2,000 – $4,000	

(b) **What is the loan interest finance charge to be included in the statement of profit or loss for the year? (2 marks)**

$______

(c) **How should the 6% loan (20X3) be classified in the statement of financial position as at 31 December 20X1? (1 mark)**

	Selection
Non-current asset	
Current liability	
Non-current liability	

(d) **State whether the following statement is true or false. (1 mark)**

The loan is disclosed in the statement of changes in equity.

True/False*

* Delete which does not apply

(e) **State the amounts to be included in the financial statements for income tax in the financial statements for the year ended 31 December 20X1. (3 marks)**

Profit or loss	$
Statement of financial position	$

(Total: 15 marks)

2 **Zboc Co**

Zboc, an entity, is preparing its financial statements for the year ended 31 December 20X1. A list of balances was printed as at that date, but due to a printer problem, the income tax account balance was excluded.

	$
Revenue	760,000
Purchases	320,000
Administrative expenses	145,000
Distribution costs	59,000
Land and buildings – cost (land $200,000)	500,000
Buildings – accumulated depreciation at 1 Jan 20X1	100,000
Plant and equipment – cost	400,000
Plant and equipment – accum'd depreciation at 1 Jan 20X1	250,000
Trade and other receivables	65,000
Allowance for receivables – 1 January 20X1	1,000
Inventory – 1 Jan 20X1	43,000
Issued share capital ($1 each)	80,000
Share premium	30,000
Trade and other payables	42,000
Retained earnings – 1 Jan 20X1	325,000
Bank	59,000

Required:

Task 1

(a) **Confirm the missing income tax ledger account balance to make the trial balance totals agree.** **(3 marks)**

	$	Debit/Credit
Income tax balance		

You have now been advised the suspense account balance relates to the income tax ledger account balance that was omitted from the list above. In addition, the finance director has advised that all income tax liabilities for earlier years have now been settled and that the estimated tax liability for the year ended 31 December 20X1 is $15,000.

(b) **State the amounts you would expect to see in the financial statements for the year ended 31 December 20X1 in relation to income tax.** **(2 marks)**

Statement of profit or loss $______

Statement of financial position $______

The following notes are relevant to the preparation of the financial statements for the year ended 31 December 20X1:

(i) No entries have been made in respect of a dishonoured cheque for $6,000 from a credit customer.

(ii) Buildings are depreciated on a straight-line basis of 2% per annum. Plant and equipment is depreciated at the rate of 20% per year on a straight-line basis. This should be charged to cost of sales.

(iii) Closing inventory has been valued at $51,000. This included one item which had cost $5,000 which had been damaged and could now be sold for only $3,000 if repair work costing $500 was perform on it.

(iv) The accountant of Zboc believes that the allowance for receivables can be reduced to $500.

Task 2

(a) **'Drag and drop' the following two items to state the accounting entries required to account for the dishonoured cheque.**

Items: Credit/Debit **(2 marks)**

	Selection
Revenue	
Trade and other receivables	
Cash at bank	
Trade and other payables	

(b) **What is the depreciation charge to be included in the statement of profit or loss for the year?** **(2 marks)**

Buildings $______

Plant and equipment $______

(c) **At what valuation should closing inventory be included in the financial statements for the year ended 31 December 20X1?** **(2 marks)**

$______

Task 3

Which of the following correctly calculates the figure to include in the statement of financial position for net trade receivables after adjustment for the allowance for receivables? **(2 marks)**

	Selection
$65,000 + $6,000 – $1,000	
$65,000 – $500	
$65,000 + $6,000 – $500	

Task 4

During the year, Zboc Co made a '1 for 5' bonus issue of shares. The bonus issue has not yet been accounted for.

State the accounting entries required to record the bonus issue made during the year. **(2 marks)**

	Ledger Account:	$
Debit		
Credit		

(Total: 15 marks)

3 **P Co and S Co**

The statements of profit or loss of two entities, P Co and S Co, for the year ended 31 December 20X3 are presented below:

	P Co	S Co
	$000	$000
Revenue	950	424
Cost of sales	(400)	(152)
Gross profit	550	272
Administrative expenses	(200)	(120)
Operating profit	350	152
Investment income	60	20
Finance costs	–	(8)
Profit before tax	410	164
Income tax	(100)	(32)
Profit after tax for the year	310	132

The following notes are relevant to the preparation of the consolidated financial statements:

(i) P Co acquired 80% of the ordinary shares in S Co on 1 October 20X3.

(ii) During the post-acquisition period, S Co sold goods to P Co for $50,000 making a gross profit margin of 20%. Forty per cent of these goods remained in the inventory of P Co at the year end.

Task 1

Complete the following consolidated statement of profit or loss for the P Co group for the year ended 31 December 20X3 (10 marks)

	$000	
Revenue		
Cost of sales	Item 1	Add/Subtract*
	–––––	
Gross profit	N/A	
Administrative expenses		Add/Subtract*
	–––––	
Operating profit	N/A	
Investment income		Add/Subtract*
Finance costs		Add/Subtract*
	–––––	
Profit before taxation	N/A	
Income tax		Add/Subtract*
	–––––	
Profit after tax for the year	N/A	
	–––––	
Profit after tax attributable to:		
Owners of P Co	N/A	
Non-controlling interest	Item 2	
	–––––	
	N/A	
	–––––	

Note: * = delete which does not apply

Item 1 – Choose the correct calculation for cost of sales

	All figures are in $000	**Selected answer**
(i)	($400 + (9/12 × $152) – $50 + $4	
(ii)	($400 + (3/12 × $152) + $50 – $4	
(iii)	($400 + (3/12 × $152) – $50 + $4	

Item 2 – Choose the correct calculation for the non-controlling interest share of the consolidated profit for the year

		Selected answer
(i)	(3/12 × 20% × $132) – ($50 × 20% × 40%)	
(ii)	(3/12 × 20% × $132) – ($50 × 20% × 40% × 20%)	
(iii)	(9/12 × 20% × $132) – ($50 × 20% × 40% × 20%)	

Task 2

P Co is considering the purchase of a shareholding in another entity and, if purchased, this investment would meet the definition of an associate.

Complete the following statement to explain what an interest in an associate is. (2 marks)

An interest in an associate would normally be indicated by a owning a shareholding in that entity of up to 20%/between 20% and 50%*. An interest in an associate is normally characterised by being able to exercise control/ significant influence* over the strategic and operating decisions in that entity.

* delete which does not apply

Task 3

State whether each of the following statements is true or false. (3 marks)

		True/False
(i)	A highly-geared entity will always have a higher operating profit percentage than an ungeared entity undertaking similar business activities	
(ii)	If the average trade receivables collection period has increased from 35 days to 45 days, this is not always an indication of poor credit control by an entity	
(iii)	If an entity purchases an item of plant and equipment for cash during the year, this will be disclosed in the statement of cash flows for the year as an investing activity	

(Total: 15 marks)

4 **BC Co and YZ Co**

The statements of financial position for BC and YZ as at 31 December 20X7 are presented below

	BC	YZ
	$000	$000
Assets		
Non-current assets		
Property, plant and equipment	240	298
Investment	400	–
Current assets:		
Inventories	75	56
Trade and other receivables	120	94
Cash and cash equivalents	5	52
Total assets	840	500
Equity and liabilities		
Equity		
Issued share capital	300	250
Retained earnings	342	172
Non-current liabilities:		
7% Bank loan 20X9	100	20
Current liabilities:		
Trade and other payables	98	58
Trade equity and liabilities	840	500

The following notes are relevant to the preparation of the consolidated financial statements for the year ended 31 December 20X7:

(i) BC Co acquired 75% of the ordinary shares of YZ Co for $400,000 several years ago. At the acquisition date, the retained earnings of YZ Co were $100,000. The fair value of the non-controlling interest in YZ Co at acquisition was $100,000.

(ii) The carrying amount of the net assets of YZ Co approximated their fair values, with the exception of a plot of land. This land was recorded in the accounts of YZ Co at its cost of $60,000 but was estimated to have a fair value of $100,000. This land is still owned by YZ Co at 31 December 20X7.

(iii) During the year, BC Co sold goods on credit to YZ Co for $20,000, on which it earned a margin of 30%. At the reporting date, two-thirds of these goods were still included in the inventories of YZ Co. In addition, the trade receivable and trade payable outstanding between the two entities had not been settled by the reporting date.

Required:

Task 1:

(a) **Choose the correct calculation of goodwill upon acquisition of YZ Co.** **(2 marks)**

		Selected answer
(i)	\$400,000 + \$100,000 – (\$250,000 + \$100,000 + \$40,000)	
(ii)	\$400,000 – \$100,000 – (\$250,000 + \$100,000 + \$40,000)	
(iii)	\$400,000 + \$100,000 – (\$250,000 + \$100,000 – \$40,000)	

(b) **Identify which one of the following would be the correct classification for goodwill in the consolidated statement of financial position.** **(1 mark)**

		Selected answer
(i)	A tangible non-current asset	
(ii)	An intangible non-current asset	
(iii)	A current asset	

Task 2

Complete the following table to state at what amount each of the following items should be included in the consolidated statement of financial position at 31 December 20X7. **(5 marks)**

		\$000
(i)	Property, plant and equipment	
(ii)	Inventories	
(iii)	Trade receivables	
(iv)	Trade and other payables	
(v)	7% Bank loan 20X9	

Task 3

(a) **What amount should be included in the consolidated statement of financial position for the non-controlling interest as at 31 December 20X7? (2 marks)**

$000

(b) **What amount should be included in the consolidated statement of financial position for retained earnings as at 31 December 20X7? (2 marks)**

$000

Task 4

State whether each of the following statements is true or false. (3 marks)

		True/False
(i)	The income and expense of an associate are cross-cast with those of the parent and subsidiary on a line-by-line basis for inclusion in the consolidated statement of profit or loss	
(ii)	If an entity made a rights issue of shares during the year, with all other factors remaining unchanged, this would have a detrimental impact upon the current ratio	
(iii)	If an entity revalued its land and buildings from $1 million to $1.6 million during an accounting period, with all other factors remaining unchanged, this would reduce the gearing ratio	

(Total: 15 marks)

Chapter

22

PRACTICE ANSWERS

Section A: Answers to Objective Test Questions

The regulatory and conceptual framework

1 **D**

2 **D**

3 **A**

4 **A**

5 **D**

The other three options contain items that are not considered to contribute towards reliability.

6 **D**

Double-entry bookkeeping

7 **D**

8 **C**

9 **C**

10 **B**

11 **C**

12 **B**

13 **D**

14 **C**

Asset and liability ledger account balances are carried forward to form the opening balances for the next accounting period. They are also used to compile the statement of financial position.

Recording transactions and events

15 **$1,260**

Sales tax

	$		$
Purchases	2,100	Sales	3,500
(17.5% × 12,000)		23,500 × 17.5/117.5	
Expenses	140		
(17.5% × 800)			
Bal c/f	1,260		3,500
		Bal b/f	1,260

16 **B**

17 **B**

Sales tax

	$		$
Purchases	3,150.00	Sales	4,112.50
(17.5 % × 18,000)		27,612.50 × 17.5/117.5	
Bal c/f	962.50		
	4,112.50		4,112.50
		Bal b/f	962.50

18 **D**

		$	$
Assets	Bank (1,000 + 1,175)		2,175
	Inventory		400
			2,575
Liabilities	Payables (800 × 1.175)	940	
	Sales tax (175 – 140)	35	
			(975)
			1,600
Capital	Capital introduced		1,000
	Profit (1,000 – 400)		600
			1,600

19 **C**

Trade discount is always deducted at source by the seller: ($6,000 × 90%) = $5,400 and this will be recorded by the purchaser. If the purchaser subsequently makes early payment and is entitles to deduct settlement discount, only the net amount will be paid and discount received will be recorded.

20 **B**

Trade discount is always deducted at source by the seller: ($8,000 × 90%) = $7,200. As the seller expects the customer to make early settlement, this discount is also deducted by the seller: ($7,200 × 90%) = $6,480. If the customer subsequently does not pay within the settlement discount period, $7,200 will be payable. This will result in the seller recording additional revenue of $720 ($7,200 – $6,480) when the cash is received.

Inventory

21 **$550**

	A	**B**	**C**	**Total**
	$	$	$	$
Cost	7	10	19	
NRV	13	8	14	
Lower of cost or NRV	7	8	14	
× Number of units	20	25	15	
Valuation	140	200	210	550

22 **A**

(35 × $15) + (30 × $20) = $1,125

23 **C**

No change is required as inventory is stated at the lower of cost and net realisable value.

24

	Selection
Carriage outwards	
Depreciation of factory plant	Correct
Carriage inwards	Correct
General admin overheads	

25 **$122,900**

400 items		$
Cost	400 × $4	1,600
NRV	(400 × $3) – $200	1,000

Therefore use NRV.

200 items		$
Cost	200 × $30	6,000
NRV	(200 × $35) – $1,200 – $300	5,500

Therefore use NRV.

Total inventory figure = $116,400 + $1,000 + $5,500 = $122,900.

26 **C**

Tangible non-current assets

27 **$3,291**

	$
Assets held all year ($15,000 – 8,000) × 25%	1,750
Asset disposed of $8,000 × 25% × 8/12	1,333
Asset acquired $10,000 × 25% × 1/12	208
Total depreciation	3,291

28 **D**

29 **$28.80 loss**

	$
Proceeds of sale	1,200.00
CA at disposal (2,400 – 480 – 384 – 307.20)	(1,228.80)
Loss on disposal	(28.80)

Depreciation to disposal

Yr 1: $2,400 × 20% = $480

Yr 2: $(2,400 – 480) × 20% = $384

Yr 3: $(2,400 – 480 – 384) × 20% = $307.20

30 **$112,000**

$100,000 + $7,000 + $5,000 = $112,000

Training costs are not classified as asset expenditure.

31 **$540**

	$
Assets held all year (5,000 – 300 – 600) × 10%	410
Disposals	
$300 × 10% × 2/12	5
$600 × 10% × 10/12	50
Acquisition $1,000 × 10% × 9/12	75
Depreciation charge for the year	540

32 **$2,500**

$$\frac{\$30{,}000 - \$6{,}000}{4} \times \frac{5}{12} = \$2{,}500$$

33 **$280,000**

	$
Cost of warehouse	300,000
Accumulated depreciation to disposal date	
($300,000 / 50) × 30	180,000
Carrying amount at revaluation date	120,000
Revaluation surplus	280,000
Revaluation	400,000

34 **$14,000**

	$
Original annual depreciation charge	6,000
$300,000 / 50 years	
Depreciation charge following revaluation	
($400,000 / 20 years	20,000
Amount of annual transfer of ‘excess depreciation’	14,000

35 **$220,000**

	$
Revalued amount at 1 January 20X4	400,000
Depreciation charge – 6 years to disposal	
($400,000 / 20 years × 6 years	120,000
	–––––––
Carrying amount at disposal date	280,000
Disposal proceeds	500,000
	–––––––
Profit on disposal	220,000
	–––––––

Intangible assets

36 **C**

37 **C**

38 **D**

Accruals and prepayments

39 **$150 and $1,525**

Electricity

	$		$
Bank	400	Bal b/f	250
Bank	350		
Bank	425	Profit or loss (balancing figure)	1,525
Bank	450		
Bal c/f (1/3 × 450)	150		
	–––––		–––––
	1,775		1,775
	–––––		–––––

40 **$1,300 and $75 accrual**

Electricity

	$		$
Bal b/f	25	Bal b/f	
Bank (12 × 100)	1,200	Profit or loss	1,300
		(350 + 375 + 275 + 300)	
Bal c/f (ß)	75		
	1,300		1,300
		Bal b/f	75

41 **$1,200**

Rent

	$		$
Bal b/f	200	Profit or loss (ß)	1,200
Bank	1,200	Bal c/f	200
	1,400		1,400
Bal b/f (2/12 × 1,200)	200		

42 **$1,160**

Light and heat

	$		$
Bank (240 + 10)	250	Bal b/f	240
Bank	260		
Bank	220		
Bank	210	Profit or loss (ß)	1,160
Bank	230		
Accrual c/f	230		
	1,400		1,400
		Bal b/f	230
		(last quarter's bill)	

43 **$1,340**

Stationery

	$		$
		Bal b/f	80
Bank	1,350	Expense to P&L (ß)	1,340
Bal c/f	70		
	1,420		1,420
		Bal b/f	70

Receivables

44 **$46,550**

$50,000 – $1,000 – $2,450 = $46,550

45 **$3,700 and $76,500**

Receivables

	$		$
Bal b/f	82,500	Irrecoverable debts	4,750
		Bal c/f	77,750
	82,500		82,500
Bal b/f	77,750		

Irrecoverable debts expense

	$		$
Receivables	4,750	Decrease in allowance	750
(1000 + 500 + 3250)		Bank receipt from debt previously written off	300
		Profit or loss account	3,700
	4,750		4,750

	$	
Allowance required at 31 March	1,250	
Opening allowance	2,000	
Movement in allowance balance	750	decrease

Net receivables = $77,750 – $1,250 = $76,500

46 **$260**

Allowance for receivables

	$		$
		Bal b/f	700
Irrecoverable debts (ß)	360		
Bal c/f	340		
	700		700
		Bal b/f	340

Irrecoverable debts

	$		$
Receivables	450	Decrease in allowance	360
Receivables	170	Profit or loss account (ß)	260
	620		620

47 **$400**

Receivables

	$		$
Bal b/f	47,800	Bank	150
		Irrecoverable debts	150
		Bal c/f	47,500
	47,800		47,800
Bal b/f	47,500		

Irrecoverable debt expense

	$		$
Increase in allowance	250	Profit or loss expense	400
Receivables	150		
	400		400

48 **$99,500 and $3,035**

Receivables

	$		$
Bal b/f	100,000	Bank	500
		Bal c/f	99,500
	100,000		100,000
Bal b/f	99,500		

Allowance for receivables

	$		$
		Bal b/f	5,000
Profit or loss	1,965		
Bal c/f	3,035		
	5,000		5,000
		Bal b/f	3,035

49 **B**

This is an example of an irrecoverable debt being written off. Credit the receivables account in order to clear the debt and debit the irrecoverable debts account with the amount of the debt written off.

50 **A**

The bad debt of $1,582 already been removed from receivables during the year. The specific allowance of $900 (it has not yet been written off as bad) will be offset against receivables in the year-end financial accounts.

51 **D**

52 **A**

$8,500 – ($400 × 2) = $7,700

53 **A**

The other three lists all contain one item which should appear on the debit side of the account.

54 **$30,000**

Trade receivables' control account

	$		$
Bal b/f	22,000	Bank	115,000
Sales	120,000		
Dishonoured cheque	9,000	Contra	6,000
		Bal c/f	30,000
	151,000		151,000
Bal b/f	21,000		

Note that discount received relates to early payment of trade payables, and is therefore not relevant in this question. When a customer's payment has been dishonoured, the receivable must be reinstated. It may subsequently be written off as irrecoverable.

55 **C**

Payables, provisions and contingent liabilities

56 **B**

57 **C**

58 **C**

59 **B**

60 **D**

61 **$37,700**

Payables

	$		$
Bank	123,500	Bal b/f	33,600
Discounts received	3,700		
Contra with receivables	8,700	Purchases	140,000
Bal c/f (ß)	37,700		
	173,600		173,600
		Bal b/f	37,700

62 **$164,300**

Payables

	$		$
Bank	146,500	Bal b/f	49,200
Discounts received	6,200		
Contra with receivables	4,800	Purchases (ß)	164,300
Returns outwards	5,400		
Bal c/f	50,600		
	213,500		213,500
		Bal b/f	137,800

Capital structure and finance costs

63 **$18,000 and $23,000**

	$
2005 estimate	23,000
Overprovision 2004	(5,000)
	18,000
Tax liability	23,000

64 **B**

		$
Preference dividends (6% × 1,000,000	=	60,000
Ordinary dividends (16,000,000 × 0.02)	=	320,000
Total dividend	=	380,000

65 **B**

66 **A**

67 **$100,000**

	$
Profit after tax (balancing figure)	100,000
Dividends	(50,000)
Profit for year	50,000
Accumulated profit b/f	50,000
Accumulated profit c/f	100,000

Reconciliations

68 **C**

	$	
Balance per bank statement (ß)	($2,360)	o/d
Add: Outstanding cheques	($1,420)	
Balance per bank ledger account (3,600 + 180)	($3,780)	o/d

69 **D**

Bank

	$		$
		Bal b/f (i)	5,670
Bal c/f	5,920	Bank charges (ii)	250
	5,920		5,920

		$
Balance per bank statement (ß)		(6,100)
Add:	Error removed (iii)	(40)
Add:	Outstanding cheques (iv)	(325)
Less:	Outstanding lodgements (v)	545
Balance per bank ledger account		(5,920)

70 **$1,405 debit**

Bank

	$		$
Cash sales	1,450	Bal b/f	485
Receivables	2,400	Payables (0.95 × $1,800)	1,710
		Dishonoured cheques	250
		Bal c/f	1,405
	3,850		3,850
Bal b/f	1,405		

71 **D**

Bank

	$		$
Standing order	125	Bal b/f	5,675
		Dishonoured cheque ($450 × 2)	900
Bal c/f	6,450		
	6,575		6,575
		Bal b/f	6,450

72 **$700 overdrawn**

The bank reconciliation should have been prepared as follows:

	$
Overdraft per bank statement	(38,600)
Add deposits not yet credited	41,200
	2,600
Less outstanding cheques	(3,300)
Overdraft per bank ledger account	(700)

73 **A**

Items 3 and 4 relate to timing differences only and would appear in the bank reconciliation.

74 **B**

Correction of errors and suspense accounts

75

	Ledger Account:	$
Debit	Payables' ledger control account	90
Credit	Purchases returns	90

76 **$11,755**

Draft profit for the period	$12,355
Six months' rent 6/12 × 800	($400)
Closing Inventory adjustment (1,000 – 800)	($200)
	$11,755

77 **$11,755**

Draft profit for the period	$36,834
Contra affects only the statement of financial position	N/A
Fixtures and fittings depreciation charge	($870)
	$35,964

78 **B**

The profit will be understated by the following amount:

	$
Amount charged in error to the repairs account	38,000
Less depreciation chargeable on the plant (3/12 × 20% × $38,000)	(1,900)
	36,100

79 **$28,454 loss**

Draft loss for the period	$(26,834)
Irrecoverable debt written off	(750)
Reduction in allowance for receivables	($870)
	$(28,454)

80

	Ledger Account:	$
Debit	Revaluation surplus	10,000
Credit	Share premium	10,000

81

	Ledger Account:	$
Debit	Accumulated depreciation	18,000
Credit	Revaluation surplus	18,000

The increase in the carrying value of the premises is from $82,000 ($100,000 - $18,000) to $125,000 = $43,000 revaluation surplus.

82

	Ledger Account:	$
Debit	Suspense	4,800
Credit	Disposal of machine	4,800

The part-exchange value is a part-contribution to the cost of the new machine and also the disposal value of the old machine, included in the calculation of profit or loss on disposal.

Preparing basic financial statements

83 **C**

84 **C**

85 **A**

86 **C**

87 **C**

88

	$	
Depreciation charge	11,600	(2% × $580,000)
Carrying amount	452,400	$580,000 – ($116,000 + $11,600)

89

	$	
Depreciation charge	9,375	25% × $37,500 ($50,000 – $12,500)
Carrying amount	28,125	$50,000 – ($12,500 + $9,375)

90

	$
Irrecoverable debt expense	4,230
Carrying amount	21,470

	$
Irrecoverable debts $1,800 + 3,200 =	5,000
Decrease in allowance for receivables	(770)
Total irrecoverable debt expense	4,230
Receivables ($25,800 – 3,200)	22,600
Less: Closing allowance for receivables	(1,130)
Net closing receivables	21,470
Allowance for receivables:	
Closing allowance for receivables	1,130
Opening allowance for receivables	1,900
Decrease in allowance for receivables to P&L	770

91 **B**

	Charge for the year			Closing
	$			$
Rent	**36,000**	**Rent accrual**		**2,000**
	(12 × $3,000)	Due	36,000	
		Paid	34,000	
		Accrual	2,000	
Insurance	**24,000**	**Insurance prepayment**		**6,000**
		Paid	30,000	
		Due	24,000	
		Prepayment	6,000	

92 **C**

93 **A**

94 **B**

The other lists contain adjusting items.

95 D

Revenue is recognised on the provision of services aver the time period that the service is provided.

Incomplete records

96 **$860 loss**

Change in net assets = Change in share capital + Profits for the year

Opening net assets = $7,600 (i.e. all the assets purchased and the remaining cash)

Closing net assets = $6,740

There is no change in share capital after incorporation

($860) = 0 + Profit/loss for the year

Loss for year = $860

97 **$14,000**

Change in net assets = Change in share capital + profit for year – dividends paid

$27,000 – $10,000 = Change in share capital + $5,000 – $2,000

Share capital issued = $14,000

98 **B**

	%
Sales	115
Cost of Sales	100
Gross profit	15

15/115 = 13.04%

99 **B**

Closing net assets – opening net assets = share capital issued + profit for year – dividends

$4,500 – $10,000 = $4,000 + profit/(loss) – $8,000

Loss for year = $1,500

100 **$578,200**

Payables

	$		$
Bank	542,300	Bal b/f	142,600
Discounts received	13,200		
Returns outwards	27,500	Purchases (ß)	578,200
Bal c/f	137,800		
	720,800		720,800
		Bal b/f	137,800

101 **D**

Cost of Sales = 75% × $17,000 = $12,750

Purchases = $12,750 + $1,350 – $3,500 = $10,600

102 **$525,300**

Credit sales can be calculated as a balancing figure on the receivables' general ledger account.

Receivables

	$		$
Balance b/f	29,100	Bank takings	381,600
		Expenses	6,800
Credit sales (balance)	414,500	Irrecoverable debts	7,200
		Contra with payables' general ledger account	9,400
		Balance c/f	38,600
	443,600		443,600

Total sales = Credit sales $414,500 + cash sales $112,900 – returns $2,100 = $525,300.

Note – if goods have been returned and a refund given to a cash sale customer, the accounting entries will be:

Dr Returns inward (sales returns), and Cr; Bank.

Returns inwards are will be offset against sales.

103 **$140,000**

	%
Opening inventory	17,000
Purchases	91,000
Closing inventory	(24,000)
Cost of sales	84,000

Sales = $84,000 × 100/60 = $140,000

104 **A**

The rent expense for the year should be:

(5/12 × $24,000) + (7/12 × $30,000) = $27,500

105 **$32,640**

Cost of sales = 70% × $64,800 = $45,360

	$
Opening inventory	28,400
Purchases	49,600
Cost of sales	(45,360)
Loss of inventory	32,640

Statement of cash flows

106 **C**

107 **B**

Income tax

	$		$
Bank (ß)	53,000	Bal b/f	50,000
Bal c/f	57,000	Profit or loss	60,000
	110,000		110,000
		Bal b/f	57,000

108 **$44,250**

	$
Increase in retained earnings ($85,500 – $45,500)	40,000
Dividends	3,300
Taxation ($800 + $550 – $400)	950
Profit before tax	44,250

109 **$10,000 inflow**

	$	
Proceeds – issue of share capital ($20,000 + $10,000)	30,000	inflow
Repayment of loan notes	20,000	outflow
	10,000	inflow

110 **$16,000**

Loan interest payable

	$		$
Bank (ß)	12,000	Bal b/f	5,000
Bal c/f	3,000	Profit or loss	10,000
		($100,000 × 10%)	
	15,000		15,000
		Bal b/f	3,000

Preference dividends 8% × $50,000 = $4,000

Total payments = $12,000 + $4,000 = $16,000

111 **$20,000**

112 **B**

All other lists contain one or more items that would not appear in the calculation of net cash from operating activities.

Interpretation of financial statements

113 **A**

20X6 600/2,500 = 24%

20X5 410/2,000 = 20.5%

114 **D**

20X6 500/2,500 = 20%

20X5 500/2,000 = 25%

115 **46 days**

Opening inventory + purchases – closing inventory = cost of sales

6,000 + purchases – 3,800 = 40,000

Purchases = 40,000 + 3,800 – 6,000 = 37,800

4,750/37,800 × 365 = 46 days

116 **A**

Current ratio

18,940/7,221 = 2.62

Quick ratio

10,420 + 3,200 = 13,620/7,221 = 1.89

117 **A**

Inventory turnover = cost of sales/closing inventory

Cost of sales = 22,000 + 150,000 – 26,000 = 146,000

Inventory turnover = 146,000/26,000 = 5.6 times

118 **28 days**

(35,250 / 460,000) × 365 = 27.97 = 28 days

Remember that cash sales are excluded as those sales were not been made on credit.

119 **30 days**

(70,000 / 850,000) × 365 = 30.05 = 30 days

Remember that cash purchases are excluded as those purchases were not made on credit. Ideally, for this calculation, credit purchases would be used. However, it is often not available, and cost of sales would therefore be used as the nearest approximation to the credit purchases figure.

120 **29 days**

First, calculate cost of sales: 81,000 + 958,000 – 77,000 = $962,000

Then, calculate the average inventory holding period as follows:

(77,000 / 962,000) × 365 = 29.21 = 29 days

Note that all purchases of goods for resale are included, not just purchases on credit.

Consolidated statement of financial position

121 **A**

	$
Cost of investment	400,000
FV of NCI @ acquisition	100,000
Less NA @ acquisition	(350,000)
	150,000

122 **$43,750**

	$
Retained earnings 40,000 + (5,000 × 75%)	43,750

123 **$209,000**

	$
Retained earnings (200,000 + (15,000 × 60%))	209,000

124 **$79,000**

	$
FV of NCI @ acquisition	75,000
Share of post-acquisition profits (20% × $20,000)	4,000
	79,000

125 **$250,000**

	$
Cost of investment	750,000
FV of NCI @ acquisition	150,000
Less NA @ acquisition	(650,000)
	250,000

126 **A**

Subsidiaries are consolidated in full and associates are equity accounted.

127 **B**

128 **$19,200**

(60% × 10,000 × $2) + (60% × 10,000 × 2/5 × $3)

129 **$220,000**

(80% × 30,000 × $2.50) + (80% × 30,000 × 5/3 × $4)

Consolidated statement of profit or loss

130 **$22 million**

Revenue = X $16 + Y $8 – Intra-group transaction $2 = $22.

Y is a subsidiary and Z is an associate. Therefore Z's revenue will not be included and the intra-group sales with Z will not be eliminated.

131 **$19 million**

11 + 10 – 3 (intra group trading) + 1 (PURP) = 19

132 **A**

Profit = (600 – 338 – 113 – 38) × 30% = 33,300

133 **$72,000**

Profit = (960 – 540 – 180 – 60) × 40% = 72,000

134 **C**

Sales $600 – Cost $500 = Profit $100

Half of these goods are in inventory = PURP $100 × ½ = $50 which needs to be added back to cost of sales

135 **$4,960**

(20% × $25,000) – (20% × ($900 × 1/3 × 2/3)

Section B: Answers to Multi-task Questions (MTQ)

1 **Symmetry Co**

Task 1

(a) **'Drag and drop' the following two items to identify in which statement of profit or loss heading they should be included.** **(2 marks)**

	Selection
Revenue	Returns inwards
Cost of sales	Returns outwards
Distribution expenses	
Administrative expenses	

(b) **What is the depreciation charge to be included in the statement of profit or loss for the year?** **(2 marks)**

$8,500 — 10% × ($120,000 – $35,000)

(c) **At what valuation should closing inventory be included in the financial statements for the year ended 31 December 20X1?** **(2 marks)**

$13,990 — $14,000 – $100 + (130 – $40)

Task 2

(a) **Which of the following correctly calculates the figure to include in the statement of financial position for net trade receivables?** **(2 marks)**

	Selection
$30,500 – $2,000	
$30,500 – $2,000 – $4,000	Correct
$30,500 + $2,000 – $4,000	

(b) **What is the loan interest finance charge to be included in the statement of profit or loss for the year?** **(2 marks)**

$2,000 — 6% × 4/12 × $100,000

(c) **How should the 6% loan (20X3) be classified in the statement of financial position as at 31 December 20X1? (1 mark)**

	Selection
Non-current asset	
Current liability	
Non-current liability	Correct

(d) **State whether the following statement is true or false. (1 mark)**

The loan is disclosed in the statement of changes in equity. False

(e) **State the amounts to be included in the financial statements for income tax in the financial statements for the year ended 31 December 20X1. (3 marks)**

Profit or loss	$6,000
Statement of financial position	$5,000

Note that the profit or loss charge consists of the under-provision relating to earlier years (the debit balance of $1,000 in the trial balance), plus the estimated liability for the current year of $5,000.

(Total: 15 marks)

2 **Zboc Co**

Task 1

(a) **Confirm the missing income tax ledger account balance to make the trial balance totals agree. (3 marks)**

	$	Debit/Credit
Income tax balance	3,000	Credit

(b) **State the amounts you would expect to see in the financial statements for the year ended 31 December 20X1 in relation to income tax. (2 marks)**

Statement of profit or loss	$12,000	(15,000 – $3,000)
Statement of financial position	$15,000	

The credit balance on the income tax account represents an over-provision that is no longer required. This can be released to the statement of profit or loss and be offset against the expense for the current year tax charge of $15,000.

Task 2

(a) **'Drag and drop' the following two items to state the accounting entries required to account for the dishonoured cheque.**

Items: Credit/Debit **(2 marks)**

	Selection
Revenue	
Trade and other receivables	Debit
Cash at bank	Credit
Trade and other payables	

(b) **What is the depreciation charge to be included in the statement of profit or loss for the year?** **(2 marks)**

Buildings (exclude land)	\$6,000	2% × \$300,000
Plant and equipment	\$80,000	20% × \$400,000

(c) **At what valuation should closing inventory be included in the financial statements for the year ended 31 December 20X1?** **(2 marks)**

\$48,500 \$51,000 – \$5,000 + (\$3,000 – \$500)

Task 3

Which of the following correctly calculates the figure to include in the statement of financial position for net trade receivables after adjustment for the allowance for receivables? **(2 marks)**

	Selection
\$65,000 + \$6,000 – \$1,000	
\$65,000 – \$500	
\$65,000 + \$6,000 – \$500	Correct

Note: remember to include the reinstated receivable of \$6,000 from the dishonoured cheque, and also deduct the allowance for receivables which should be adjusted to \$500.

Task 4

During the year, Zboc Co made a '1 for 5' bonus issue of shares. The bonus issue has not yet been accounted for.

State the accounting entries required to record the bonus issue made during the year. (2 marks)

	Ledger Account:	$
Debit	Share premium	16,000
Credit	Issued share capital	16,000

The number of shares issued will be 80,000/5 = 16,000. This will increase share capital and the debit entry can be made against share premium.

(Total: 15 marks)

3 **P Co and S Co**

Task 1

Complete the following consolidated statement of profit or loss for the P Co group for the year ended 31 December 20X3. (10 marks)

	$000	
Revenue ($950 + (3/12 × $424) – $50	1,006	
Cost of sales $400 + (3/12 × $152) – $50 + $4 (item 1)	392	Subtract
Gross profit	614	
Administrative expenses ($200 + (3/12 × $120))	230	Subtract
Operating profit	384	
Investment income ($60 + (3/12 × $20))	65	Add
Finance costs ($0 + (3/12 × $8))	2	Subtract
Profit before taxation	447	
Income tax ($100 + (3/12 × $32))	108	Subtract
Profit after tax for the year	339	
Profit after tax attributable to:		
Owners of P Co	N/A	
Non-controlling interest (Item 2)	5.8	
	N/A	

Item 1 – Choose the correct calculation for cost of sales

	All figures are in $000	**Selected answer**
(i)	($400 + (9/12 × $152) – $50 + $4	
(ii)	($400 + (3/12 × $152) + $50 – $4	
(iii)	($400 + (3/12 × $152) – $50 + $4	Correct

Item 2 – Choose the correct calculation for the non-controlling interest share of the consolidated profit for the year

		Selected answer
(i)	(3/12 × 20% × $132) – ($50 × 20% × 40%)	
(ii)	(3/12 × 20% × $132) – ($50 × 20% × 40% × 20%)	Correct
(iii)	(9/12 × 20% × $132) – ($50 × 20% × 40% × 20%)	

Task 2

Complete the following statement to explain what an interest in an associate is. (2 marks)

An interest in an associate would normally be indicated by a owning a shareholding in that entity of **between 20% and 50%.** An interest in an associate is normally characterised by being able to exercise **significant influence** over the strategic and operating decisions in that entity.

Task 3

State whether each of the following statements is true or false. (3 marks)

		True/False
(i)	A highly-geared entity will always have a higher operating profit percentage than an ungeared entity undertaking similar business activities	False
(ii)	If the average trade receivables collection period has increased from 35 days to 45 days, this is not always an indication of poor credit control by an entity	True
(iii)	If an entity purchases an item of plant and equipment for cash during the year, this will be disclosed in the statement of cash flows for the year as an investing activity	True

(Total: 15 marks)

4 **BC Co and YZ Co**

Task 1:

(a) **Choose the correct calculation of goodwill upon acquisition of YZ Co.** **(2 marks)**

		Selected answer
(i)	\$400,000 + \$100,000 – (\$250,000 + \$100,000 + \$40,000)	Correct
(ii)	\$400,000 – \$100,000 – (\$250,000 + \$100,000 + \$40,000)	
(iii)	\$400,000 + \$100,000 – (\$250,000 + \$100,000 – \$40,000)	

(b) **Identify which one of the following would be the correct classification for goodwill in the consolidated statement of financial position** **(1 mark)**

		Selected answer
(i)	A tangible non-current asset	
(ii)	An intangible non-current asset	Correct
(iii)	A current asset	

Task 2

Complete the following table to state at what amount each of the following items should be included in the consolidated statement of financial position at 31 December 20X7. **(5 marks)**

		\$000	\$000
(i)	Property, plant and equipment	578	240 + 298 + 40
(ii)	Inventories	127	75 + 56 – 4
(iii)	Trade receivables	194	120 + 94 – 20
(iv)	Trade and other payables	136	98 + 58 – 20
(v)	7% Bank loan 20X9	120	100 + 20

Task 3

(a) **What amount should be included in the consolidated statement of financial position for the non-controlling interest as at 31 December 20X7? (2 marks)**

$000	
118	$100 + (25% × (172 – 100))

(b) **What amount should be included in the consolidated statement of financial position for retained earnings as at 31 December 20X7? (2 marks)**

$000	
392	$342 + (75% × (172 – 100)) – ($20 × 30% × 2/3)

Task 4

State whether each of the following statements is true or false. (3 marks)

		True/False
(i)	The income and expense of an associate are cross-cast with those of the parent and subsidiary on a line-by-line basis for inclusion in the consolidated statement of profit or loss	False
(ii)	If an entity made a rights issue of shares during the year, with all other factors remaining unchanged, this would have a detrimental impact upon the current ratio	False
(iii)	If an entity revalued its land and buildings from $1 million to $1.6 million during an accounting period, with all other factors remaining unchanged, this would reduce the gearing ratio	True

(Total: 15 marks)

Chapter

23

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